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AN INTRODUCTION TO THE CRUDE OIL WINDFALL PROFIT TAX ACT OF 1980

DAVID E. KINNAN*

I. INTRODUCTION

The Crude Oil Windfall Profit Tax Act of 1980¹ (the Act) undoubtedly is one of the most publicized, but least understood, legislative enactments of recent years. Signed into law by President Carter on April 2, 1980, but retroactively effective to March 1, 1980, the Act originally was proposed by the Carter Administration as part of a program that contemplated the gradual phaseout of mandatory domestic crude oil price controls from June 1979 through September 1981.² Prior to and during the pendency of this legislation before Congress, world crude oil price levels escalated at unprecedented rates and the quarterly reports of numerous oil

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1. Act of Apr. 2, 1980, Pub. L. No. 96-223, § 101(a)(1), 94 Stat. 230 (1980) [hereinafter referred to as the Act]. This article will be limited to an examination of Title I of the Act which provides for the taxation of United States domestic crude oil production. Apart from conforming amendments to other sections of the Internal Revenue Code of 1954 [hereinafter referred to as the Code], the Act is codified at 26 U.S.C.A. §§ 4986-4998, 6050C & 6076 (1980). Titles II, III, and IV of the Act, *inter alia*, provide additional tax credits for residential energy users, create tax incentives for the development of alternative energy sources, provide energy assistance to low-income persons in the form of direct grants to the states, repeal the carryover basis rules relating to federal estate taxation, and provide an exclusion from gross income of up to \$200 of interest and dividends in 1981 and 1982 for individual taxpayers.

2. The Emergency Petroleum Allocation Act of 1973, 15 U.S.C. §§ 751-760h (1976), provided for mandatory price controls with respect to the sale of crude oil, with certain limited exceptions, through May 31, 1979. Thereafter, mandatory price controls were authorized to be extended through September 30, 1981, at the discretion of the President. *Id.* The Carter Administration elected to institute a phased program of decontrol during the referenced period in order to avoid any abrupt "shocks" to an economy already burdened by extraordinary inflationary pressures. The Carter program was designed to bring domestic crude oil prices to world levels by October 1981. The Carter program was terminated on January 28, 1981, when President Reagan issued Executive Order No. 12287, 46 Fed. Reg. 9909 (1981) which immediately removed price controls from the sale of crude oil.

companies reflected recordbreaking earnings. Because of this climate, the general public perceived the proposed Act to be a tax on the windfall profits of the so-called major oil companies. This perception no doubt was encouraged by the title the Carter Administration gave to the Act.

Notwithstanding its rather misleading title, however, the Act imposes what is essentially an excise tax on a prescribed portion of the sales price of each barrel of domestic crude oil. The tax has no direct application to the profit of a given crude oil producer or royalty owner. Instead, the Act is designed to tax that portion of the sales price of each barrel of crude oil that is in excess of the previously controlled price level, otherwise referred to in the Act as the "windfall profit."³ The Act groups crude oil into three distinct tiers and taxes the so-called windfall profit on each barrel of crude oil at rates varying from thirty percent to seventy percent depending upon the crude oil's classification or category under the United States Department of Energy's Mandatory Petroleum Price Regulations (the DOE regulations).⁴ Although crude oil prices were decontrolled on January 28, 1981, the Act provides that the DOE regulations will be considered to remain in effect for windfall profit tax purposes.⁵ Limited amounts of independent producer⁶ oil qualify for tax rates varying from thirty percent to fifty percent. While the tax is imposed on the producer of the crude oil, in most instances the tax is collected by the first purchaser, who is obligated to withhold the appropriate amount from the purchase price.⁷ The Act is intended to raise \$227.3 billion in tax revenues during the next decade. It then will be phased out gradually during a thirty-three month period beginning no later than January 1991.⁸

The Crude Oil Windfall Profit Tax Act of 1980 is considered one of the most complex pieces of tax legislation ever signed into law. The Act is complex not only because of its own terms but because it incorporates the DOE regulations as the basis for categorizing crude oil into tiers for tax classification purposes. The purpose of this article is to introduce the basic provisions of the Act through a systematic analysis of its mechanisms.

3. 26 U.S.C. § 4988(a) (West 1980).

4. 10 C.F.R. § 212 (1980).

5. 26 U.S.C.A. § 4996(b)(8)(D) (West 1980).

6. *See id.* § 4992(b)(1) (1980) for a definition of the term "independent producer."

7. 26 U.S.C. § 4995(a)1(A) (West 1980).

8. *See id.* § 4990 (1980).

II. IMPOSITION OF THE TAX

Section 4986 of the Act imposes an excise tax on the taxable crude oil that is removed from a producer's premises⁹ after February 29, 1980.¹⁰ A producer is "the holder of the economic interest with respect to the crude oil,"¹¹ and the term encompasses those having a working interest, a royalty interest, an overriding royalty interest, or a production payment with respect to the crude oil in place in the ground.¹² Taxable crude oil includes all crude oil produced from oil wells located in the United States or in its possessions.¹³ Only crude oil specifically exempted by the Act is not subject to taxation.¹⁴

The taxable event occurs when the crude oil is transported off the premises.¹⁵ As will be demonstrated, the concept of premises differs from the DOE's definition of property.¹⁶

There are exceptions to the general rule that the taxable event occurs when the crude oil is transported off the premises. The Act provides that if the conversion of crude oil into refined products begins before the oil is removed from the premises, it is treated as removed on the day when conversion begins.¹⁷ The Temporary Excise Tax Regulations further provide that crude oil shall not be considered removed from the premises if it is transported a short dis-

9. *Id.* § 4986(b) states: "[a]n excise tax is hereby imposed on the windfall profit from taxable crude oil removed from the premises during each taxable period." 29 U.S.C.A. § 4986(b)(1980) states: "The tax imposed by this section shall be paid by the producer of the crude oil."

10. *Id.* § 4996(b)(7)(A).

11. *Id.* § 4996(a)(1)(A). In the case of a partnership, the crude oil is allocated among the partners on the basis of each partner's proportionate share of the income from the crude oil. Thus, each partner is treated as the producer to the extent of its allocable share of the income. *Id.* § 4996(a)(1)(B). In the case of a trust or estate, the entity, not the beneficiary, is treated as the producer. Treas. Reg. § 150.4996-1(b) (1980) (temporary regulation cited in 45 Fed. Reg. 23395 (1980)).

12. A typical oil and gas lease provides that a royalty, for example $\frac{1}{8}$ th, will be paid to the lessor or royalty owner. This royalty is paid without reference to production. The balance of the crude oil production in this example, $\frac{7}{8}$ ths represents the working interest or operating interest. This portion bears the entire expense of production. The working interest may be divided further by the grant or reservation of an overriding royalty or by a production payment payable out of the working interest, although these interests would not bear any of the expense of production. *See id.*

13. 26 U.S.C.A. § 4996(b)(3)-(5) (West 1980).

14. *Id.* § 4996(g). *See generally* 26 U.S.C.A. § 4994 (1980), which describes the categories of exempt crude oil.

15. *Id.* § 4986(a). Treas. Reg. § 150.4996-1(d) (1980) (temporary regulation cited in 45 Fed. Reg. 23395 (1980)). "Premises" refers to each separate interest in each mineral deposit in each separate tract of land. Treas. Reg. § 1.614-1(a) (1980).

16. 10 C.F.R. § 212.72 (1980). *See text accompanying notes 22-27 infra.*

17. 26 U.S.C.A. § 4988(c)(4) (West 1980).

tance from the premises to a storage facility where it is held until sale.¹⁸ Once it is removed from the storage facility it is considered removed from the premises.¹⁹ Finally, crude oil that is produced and then reinjected into the reservoir or used on the premises to power a production process or production equipment is deemed not to have been removed for tax purposes and therefore is not subject to taxation.²⁰

III. CLASSIFICATIONS OF TAXABLE CRUDE OIL

A producer's taxable crude oil is classified into one of three tiers. The amount of crude oil windfall profit tax that is levied is determined according to this tier.²¹ The applicable tier is determined by the category in which the crude oil is classified under the DOE's June 1979 Mandatory Petroleum Price Regulations.²² The applicable DOE crude oil category in turn is determined by the identification of the appropriate DOE property from which the crude oil is produced.²³

The first step in applying the crude oil windfall profit tax to any given barrel of crude oil, then, is to determine the particular property from which it is produced. Unfortunately, the definition of property has been one of the most difficult concepts to apply under the DOE regulations. Many of the Notices of Probable Violation issued by the DOE alleging crude oil pricing violations are based in part upon the producer's alleged misapplications of the property concept. The first sentence of the property definition²⁴ has remained substantially unchanged since the inception of crude oil price controls in August 1973.²⁵ Initially, property was defined in terms of a lease or fee interest on the land's surface. Under this definition, the discovery of a separate reservoir under the same

18. Treas. Reg. § 150.4996-I(d) (1981) (temporary regulation cited in 46 Fed. Reg. 4882-4883 (1981)).

19. *Id.*

20. *Id.*

21. *See generally* 26 U.S.C.A. §§ 4987, 4991 (West 1980).

22. 10 C.F.R. § 212 (1980).

23. 'Property' means the right to produce domestic crude oil, which arises from a lease or from a fee interest. A producer may treat as a separate property each separate and distinct producing reservoir subject to the same right to produce crude oil, provided that such reservoir is recognized by the appropriate governmental regulatory authority as a producing formation that is separate and distinct from, and not in communication with, any other producing formation.

Id. § 212.72.

24. *Id.*

25. *Id.*

lease would not create a new and separate property.²⁶ An amendment to the definition²⁷ gave producers the option to define property in terms of the actual underground producing reservoirs. A separate reservoir may now be a separate property even if it is located under the same tract or lease. Any remaining controversy over the application and interpretation of the property definition within the framework of the crude oil windfall profit tax abated substantially with the demise of crude oil price control.²⁸

Once the relevant property has been identified, the crude oil produced on the property can be categorized into the appropriate windfall profit tax tier. Although crude oil has been decontrolled, the Act specifically provides that the DOE regulations are to remain in effect for purposes of the windfall profit tax.²⁹ Moreover, the Secretary of the Treasury is authorized to prescribe such changes in the application of the DOE regulations as may be necessary or appropriate to carry out the provisions of the Act.³⁰

A. Tier One

As a general rule, tier one oil consists of all domestic crude oil produced from properties that began production prior to 1979 unless the property is exempt or falls within one of the categories reflected in tiers two or three.³¹ Prior to the decontrol of crude oil prices, tier one specifically included various DOE categories of crude oil that were established for the purposes of price control. The two main DOE categories comprising tier one oil included lower tier oil, or old oil, and upper tier oil, or new oil.³² With the

26. Whether a producer had a new and separate property was critical in determining whether the crude oil produced was lower tier or upper tier. *See* note 32 *infra* and accompanying text.

27. 10 C.F.R. § 212.71 (1980). *See* note 23, *supra*.

28. *See* text accompanying note 9, *supra*.

29. 26 U.S.C.A. § 4996(b)(8)(D) (West 1980). The Act incorporates by reference the March 1979 Department of Energy [hereinafter referred to as DOE] regulations as they existed on March 1, 1979 and the June 1979 DOE regulations as they existed on June 1, 1979, including final action taken with respect to the regulations prior to June 1, 1979, and action taken before, on, or after June 1, 1979 with respect to incremental production from qualified tertiary enhanced recovery projects. *Id.* § 4996(b)(8)(B)-(C).

30. 26 U.S.C.A. § 4997(b) (West 1980).

31. *Id.* § 4991(c).

32. The DOE categories of crude oil that made up tier 1 described below, are included only to provide a historical perspective. Lower tier oil, or "old" oil, was crude oil produced and sold from property that began production prior to 1973. Prior to decontrol, lower tier oil was not subject to windfall profit taxation because its adjusted base price exceeded the controlled ceiling price. Upper tier oil, or "new" oil, was crude oil produced and sold from property that began production during the pe-

advent of decontrol, however, it is no longer necessary to distinguish between these two categories of crude oil.

Tier one oil is taxed at a seventy-percent rate, the highest imposed under the Act.³³ Independent producers are taxed at a reduced fifty-percent rate on the first thousand barrels produced per day.³⁴ Independent producer production in excess of this amount is taxed at the normal tier one seventy-percent rate.³⁵

B. *Tier Two*

Tier two oil consists of crude oil produced from stripper well properties and from an economic interest in a National Petroleum Reserve held by the United States.³⁶ As defined in the June 1979 DOE regulations, stripper well oil consists of production from a property where average daily production of crude oil per well did not exceed ten barrels per day during any preceding consecutive twelve-month period beginning after December 31, 1972.³⁷ It is not clear why National Petroleum Reserve oil was included in the Act as a taxable category since the United States, as the holder of the economic interest, in effect is taking the tax out of one pocket and putting it into another.

The tax rate on tier two oil is sixty percent.³⁸ Independent producers are taxed at thirty percent on the first thousand barrels per day. Any excess is taxed at sixty percent.³⁹

C. *Tier Three*

Tier three oil consists of newly discovered oil, heavy oil, and incremental tertiary oil.⁴⁰ The Act does not define the term "newly

riod from 1973 through 1978. Market level new crude oil described that portion of upper tier oil that could have been reclassified on a monthly percentage basis to uncontrolled oil. Marginal well oil was crude oil produced from properties with average daily production not exceeding specified levels for specified average completion depths. A portion of marginal well oil was subject to lower tier price ceilings and the remainder was subject to upper tier price ceilings. The latter two described categories were creatures of the phased decontrol program. The complex regulations governing these categories are found at 10 C.F.R. § 212.71-212.79 (1980).

33. 26 U.S.C.A. § 4987(b)(1) (West 1980).

34. *Id.* §§ 4987(b)(2), 4992(c). For discussion of the independent producer concept, *see* notes 51-54 *infra* and accompanying text.

35. 26 U.S.C. § 4992(c) (West 1980).

36. 26 U.S.C.A. § 4991(d)(1)(A)-(B) (West 1980).

37. 10 C.F.R. § 212.54 (1980). It is not clear whether injection wells may be counted for the purpose of the qualifying calculation. Litigation on this issue is pending. *See In re Dep't of Energy Stripper Well Exemption Litigation*, M.D.L. Docket No. 378, 472 F. Supp. 1282 (D. Kan. 1979).

38. 26 U.S.C.A. § 4987(b)(1) (West 1980).

39. *Id.* §§ 4987(b)(2), 4992(c).

40. *Id.* § 4991(e)(1).

discovered oil.” Instead, Congress delegated the task to the DOE.⁴¹ As defined in the June 1979 DOE regulations, “newly discovered oil” is crude oil produced from an onshore property from which there was no production during 1978 and crude oil produced from an Outer Continental Shelf property leased after December 31, 1978 from which there was no production during 1978.⁴² Effective January 1, 1981, the DOE modified the definition of newly discovered oil to include properties from which crude oil was not produced and sold in commercial quantities during 1978.⁴³

The Act, in contrast to the treatment of newly discovered oil, defines both heavy oil and incremental tertiary oil. Heavy oil consists of production from a property that “had a weighted average gravity of 16 degrees API or less” during “the last month before July 1979 in which crude oil was produced and sold from such property” or during the relevant taxable quarter.⁴⁴ Incremental tertiary oil is the volume of crude oil that otherwise would not have been produced without the use of an approved tertiary recovery technique.⁴⁵ Generally, the incremental volume of crude oil produced as a result of a qualified tertiary recovery project begun or significantly expanded after May 1979 will qualify for tier three treatment.⁴⁶

The Act incorporates a special rule for post-1978 transfers of property: crude oil produced from any portion of such property “shall not constitute oil from a stripper well property, (a tier two oil) newly discovered oil, or heavy oil (tier three oils) if such oil would not be so classified if the property had not been trans-

41. *Id.* § 4991(e)(2).

42. 10 C.F.R. § 212.79(b) (1980).

43. 45 Fed. Reg. 78,588 (1980).

44. 26 U.S.C.A. § 4991(e)(3) (West 1980).

45. *See generally id.* § 4993; Treas. Reg. § 150.4993-1-150.4993-4 (1980) (temporary regulation cited in 45 Fed. Reg. 23389-23391 (1980)); 10 C.F.R. § 212.78 (1980).

46. Tertiary recovery methods include miscible fluid displacement, steam drive injection, microemulsion, in situ combustion, polymer augmented water flooding, cyclic steam injection, alkaline flooding, carbonated water flooding, immiscible carbon dioxide displacement, or any other method approved by the Secretary of the Treasury. *See* 26 U.S.C.A. § 4993(d)(1) (1980) (temporary regulation cited in 45 Fed. Reg. 23389 (1980)), 10 C.F.R. § 212.78(c) (1980). A qualified tertiary recovery project includes one which was certified and approved under the June 1979 DOE regulations or one which reasonably can be expected to result in more than an insignificant increase in the amount of crude oil which ultimately will be recovered. *See* 26 U.S.C.A. § 4993(c)(2) (1980). In the latter instance, such a project must be begun after May, 1979 and must be properly certified. *Id.* § 4993(c)(2)(D) and (E). *See also* Treas. Reg. § 150.4993-1(b) (1980) (temporary regulation cited in 45 Fed. Reg. 23389 (1980)). Allocation rules specify which barrels of crude oil removed during any month are incremental tertiary oil. 26 U.S.C.A. § 4993(b)(3) (West 1980).

ferred."⁴⁷ The term "transfer" includes any sale, exchange, lease, sublease, gift, bequest, devise, or other disposition of rights with respect to the property.⁴⁸ The tax rate on tier three oil is thirty percent, irrespective of independent producer status.⁴⁹ This rate is the lowest tax rate imposed under the Act, and it is intended to encourage the exploration for, and production of, new, hard-to-recover crude oil.

IV. INDEPENDENT PRODUCER OIL

The Act provides a reduced rate of taxation for an independent producer's first thousand barrels per day of tier one and tier two production. For tier one oil, the special independent producer status will reduce the tax from seventy percent to fifty percent.⁵⁰ The reduction is from sixty percent to thirty percent for tier two oil. Two criteria, however, must be met before a producer is eligible for this preferential tax treatment. First, in order to qualify as an independent producer in a particular quarter the producer must not be a "retailer" or "refiner" within section 613A of the Internal Revenue Code⁵¹ (the Code). Under the Act, as it has modified the Code, a retailer is a producer who directly, or through a related party, has more than \$1,250,000 of retail sales of oil or natural gas, or products derived therefrom, during the applicable quarter.⁵² A producer is considered to be a refiner if the producer and related parties have combined refinery runs in excess of 50,000 barrels on any day of the quarter.⁵³

Second, to qualify for the reduced tax rates, the crude oil removed must be attributable to an independent producer's working interest in the property.⁵⁴ Thus, production attributable to royalty

47. 26 U.S.C.A. § 4996(e) (West 1980).

48. Treas. Reg. § 150.4996-3(b) (1980) (temporary regulation cited in 45 Fed. Reg. 23396-23397 (1980)).

49. 26 U.S.C.A. § 4987(b)(3) (West 1980).

50. *Id.* § 4987(b)(2) (West 1980); *id.*

51. *Id.* § 4992(a)-(b). *See generally* 26 U.S.C. § 613 (1976). Section 613 of the Code defines the term independent producer for the purpose of computing percentage depletion. That definition has been adopted by the Act with slight modification.

52. 26 U.S.C.A. § 4992(b)(1)-(2) (West 1980). *See also id.* § 613A(d)(2) (West Cum. Supp. 1980).

53. *Id.* § 4992(b)(1) (West 1980). *See also id.* § 613A(d)(4) (West Cum. Supp. 1980).

54. *Id.* § 4992(d)(1)(D). *See generally* note 12 *supra*. The term working interest means an operating interest as defined in § 614(d) of the Code which was in existence on January 1, 1980. A working interest may be an operating interest attributable to a qualified overriding royalty interest which existed on January 1, 1980, if a binding contract to convert such interest to an operating mineral interest existed on February 20, 1980. *See* 26 U.S.C.A. § 4992(d)(1)-(2) (West 1980); Treas. Reg. § 150.4992-1(d)(2) (1980) (temporary regulation cited in 45 Fed. Reg. 23396-23397 (1980)).

and overriding royalty interests is not eligible for the reduced independent producer rates.

V. EXEMPT OIL

Only crude oil specifically exempted from tax by the Act is not subject to the tax.⁵⁵ The five categories of exempt crude oil are set forth and described below.⁵⁶

A. *Qualified Governmental Interest*

When an economic interest in crude oil is held by a state, its political subdivisions, or by a state agency or instrumentality, the crude oil is exempt from the windfall profit tax. The sole proviso is that the net income derived from the production must be dedicated to a public purpose.⁵⁷

B. *Qualified Charitable Interest*

When an economic interest in crude oil is held by a charitable, educational, or medical institution, or by a church that dedicated its oil revenues to such an institution prior to January 22, 1980, the crude oil is exempt if the interest was held on January 21, 1980.⁵⁸

C. *Front-End Tertiary Oil*

Tertiary incentive crude, as defined in the DOE regulations,⁵⁹ is exempted from the windfall profit tax under the front-end tertiary oil exemption.⁶⁰ Until the termination of price controls on January 28, 1981, a producer could sell otherwise price-controlled crude oil at uncontrolled prices in order to provide front-end money to offset a specified portion of allowed expenses associated with enhanced oil recovery projects.⁶¹ Under the Act, crude oil that the DOE deregulated as front-end oil was exempt from the tax

55. 26 U.S.C.A. § 4996(g) (West 1980).

56. See generally 26 U.S.C.A. §§ 4991(b), 4994 (West 1980).

57. *Id.* § 4994(a). Net income means gross income reduced by production costs and severance taxes. *Id.* § 4994(a)(2).

58. *Id.* § 4994(b). The Act refers to § 170 of the Code for the definitions of charitable, educational, or medical institutions.

59. 10 C.F.R. § 212.78 (1980). See generally 26 U.S.C.A. § 4994(c) (West 1980) and Treas. Reg. § 51.4994-2 (1980).

60. 26 U.S.C.A. § 4994(c) (West 1980).

61. Recoupable allowed expenses, 75% of environmental, engineering, laboratory and certain other expenses, must have been incurred and paid after August 21, 1979 and must be attributable to the period before October 1, 1981. With respect to any particular property, the total amount of allowed expenses could not exceed \$20 million. Treas. Reg. § 51.4994-2 (1980). 10 C.F.R. § 212.78 (1980). See generally 26 U.S.C.A. § 4994(c) (West 1980).

if the financed project was on property controlled by an independent producer.⁶² A tertiary project on a property controlled by a producer other than an independent producer is not exempt from the tax. Instead, a tax refund is available for taxes paid on the front-end oil to the extent that certain qualified expenditures exceed the amount actually recouped under the DOE front-end financing program.⁶³

Although the Act defines exempt front-end oil to be that which is removed from a premise before October 1, 1981, this category of exempt crude oil apparently may have expired on January 28, 1981 with the demise of price controls inasmuch as there is, by definition, no crude oil to decontrol as front-end oil. Whether a limited tax refund is still available undoubtedly will be the subject of future litigation since the October 1, 1981 target date has not been expressly repealed.

D. *Exempt Indian Oil*

Exempt Indian oil consists of crude oil that is produced: (1) By an Indian tribe, a tribal organization, or an individual member of a tribe if the mineral interest is held in trust by the United States or is held subject to a restriction on alienation imposed by the United States; or (2) by a native corporation organized under the Alaska Native Claims Settlement Act if the crude oil is produced from mineral interests that were received under that Act, if the crude oil is removed from the premises before 1992, and if the interest is held as of January 21, 1980.⁶⁴ The exemption applies when the proceeds from the sale of oil are paid into the United States Treasury to the credit of tribal or native trust funds pursuant to law in effect prior to January 22, 1980.⁶⁵

E. *Exempt Alaskan Oil*

Exempt Alaskan oil consists of crude oil that is produced in Alaska from a well located either north of the Arctic Circle or north of the Alaska-Aleutian Mountain Range and at least seventy-five miles from the nearest point on the Trans-Alaska Pipeline System.⁶⁶ Crude oil produced at the giant Sadlerochit Reservoir at Prudhoe Bay is not exempt.⁶⁷

62. A property qualifies for this treatment if 50% or more of the operating mineral interest is held by person who were independent producers during the last quarter of 1979. 26 U.S.C.A. § 4994(c)(4)(C) (West 1980). Independent producer is defined in § 4992(b) of the Act. 26 U.S.C.A. § 4992(b) (West 1980).

63. *Id.* § 4994(c)(2).

64. *Id.* § 4994(d) (West 1980).

65. *Id.* § 4994(d).

66. *Id.* § 4994(e).

67. *Id.*

VI. COMPUTATION OF THE TAX

The windfall profit tax is imposed on each taxable barrel of crude oil removed from the premises during each calendar quarter. The windfall profit is computed by subtracting the adjusted base price and the severance tax adjustment from the removal or sale price of each barrel of crude oil.⁶⁸ The windfall profit on each barrel, however, cannot exceed ninety percent of the net income attributable to the barrel.⁶⁹ The windfall profit tax is then computed through multiplying the amount of the windfall profit by the applicable tax rate. The appropriate tier and the status of the producer as an integrated producer or an independent producer determine the tax rate.⁷⁰

A. Removal or Sales Price

The removal price is the price at which the producer sells crude oil to the first purchaser.⁷¹ If, however, the crude oil is sold to a related party,⁷² removed from the premises before it is sold,⁷³ or refined on the premises,⁷⁴ the removal price is deemed to be the constructive sales price as computed for purposes of determining gross income from the property under section 613 of the Code.⁷⁵ The Internal Revenue Service District Director is authorized to adjust the removal price in any transaction to reflect clearly the fair market value of the crude oil removed.⁷⁶

B. Base Price and Adjusted Base Price

The adjusted base price is computed by determining the base price of the crude oil produced and by adjusting that price to re-

68. *Id.* § 4988(a).

69. *Id.* § 4988(b). For a detailed discussion of the net income limitation see notes 90-96 *infra* and accompanying text.

70. The windfall profit tax that has been paid is deductible from gross income for federal income tax purposes. 26 U.S.C.A. § 4988(b) (1980). See also 26 U.S.C. § 164(a)(3) (1976). These computations are illustrated as follows: Removal or sales price - Adjusted base price - Severance tax adjustment X tax rate = windfall profit tax = Windfall profit (subject to 90% net income limitation).

71. 26 U.S.C.A. § 4988(c)(1) (West 1980).

72. *Id.* § 4988(c)(2) (West 1980). Whether a person or party is "related" is determined by Code, § 103(b)(6)(C). 26 U.S.C. § 103(b)(6)(C) (1976). Corporations are considered to be related where common ownership exceeds 50%. *Id.*

73. *Id.* § 4988(c)(3) (West 1980).

74. 26 U.S.C.A. § 4988(c)(4) (West 1980). See Treas. Reg. § 150.4988-1(b)(1) (1981) (temporary regulations cited in 46 Fed. Reg. 4876 (1981)).

75. 26 U.S.C. § 613 (1976).

76. 26 U.S.C.A. § 4996(f) (West 1980). See Treas. Reg. § 150.4988-1(b)(3) (1980) (temporary regulation cited in 46 Fed. Reg. 4876 (1981)).

flect the rate of inflation.⁷⁷ The threshold base price varies according to the tier applicable to the particular crude oil produced. The base price for tier one crude oil is defined by the Act as the ceiling price that would have applied to such oil under the March 1979 DOE regulations if it had been produced and sold in May 1979 as upper tier oil less twenty-one cents.⁷⁸ The Act provides interim rules for months beginning before October 1980 to determine base prices for tiers two and three crude oils.⁷⁹ The Secretary of the Treasury was authorized to prescribe by regulation the base prices applicable to tiers two and three for the period subsequent to September 1980.⁸⁰ Any method prescribed by the Secretary was to be designed to yield base prices that approximated, for any grade, quality, and field, the prices at which such oil would have sold in December 1979 if all domestic crude oil were uncontrolled. The average removal price was thus computed to be \$15.20 for tier two crude oil and \$16.55 for tier three crude oil.⁸¹

The adjusted base price for each tier is calculated by multiplying the base price by an inflation adjustment factor to reflect post-June 1979 inflation.⁸² Moreover, tier three crude oil receives an additional inflation adjustment of two percent per year.⁸³

77. *Id.* § 4989(b) (West 1980).

78. 26 U.S.C.A. § 4989(c) (West 1980).

79. *Id.* § 4989(d)(2), (3). Treas. Reg. § 150.4989-1(c)(2) (1980) (temporary regulations cited at 45 Fed. Reg. 75,207-75,208 & 23,387-23,388 & 63,263-63,264 (1980)).

80. 26 U.S.C.A. § 4989(d)(1) (West 1980). The Act also establishes the method for determining the base price of crude oil produced from the Sadlerochit reservoir in Prudhoe Bay. *Id.* § 4996(d).

81. *Id.* § 4989(d)(1). The Secretary published those regulations at 45 Fed. Reg. 64,574-64,578 (1980) with modifications thereto at 45 Fed. Reg. 75,206-75,208 (1980). These regulations are codified in 26 C.F.R. § 150 (1981).

82. 26 U.S.C.A. § 4989(a) (West 1980). The inflation adjustment for any calendar quarter is the percentage by which the implicit price deflator for the gross national product, for the second preceding calendar quarter, exceeds such deflator for the calendar quarter ending June 30, 1979. *Id.* § 4989(b)(1). The United States Department of Commerce issues the implicit price deflator for the gross national product.

83. The following table summarizes the procedure for determining the adjusted base price of crude oil by tier.

	Tax Rate	Producer Oil	Average Adjusted Base Price as of March 1, 1980	Quarterly Adjustment
Tier 1	70%	50% *	\$13.06	Inflation
Tier 2	60%	30% *	\$15.50	Inflation
Tier 3	30%	30%	\$16.96	Inflation plus 2%

* First thousand barrels per day.

See *id.* § 4989 (West 1980).

C. Severance Tax Adjustment

The first step in computing the severance tax adjustment figure is to determine the actual severance tax paid to a state. A qualifying severance tax for the purposes of the Act is one that is imposed by the state on the extraction of crude oil and that is determined on the basis of the gross value of the crude oil extracted.⁸⁴ To qualify, the state tax must apply uniformly to the gross value of each barrel produced and not just to the windfall profit portion of the barrel. Moreover, a qualifying severance tax may not be determined on the basis of volume, flat rate per barrel, reserves in the ground, or net proceeds from production.⁸⁵ Finally, a qualifying state severance tax is not taken into account for adjustment purposes to the extent that it exceeds fifteen percent of the gross value of the crude oil.⁸⁶

The second step in determining the severance tax adjustment figure is to ascertain what the severance tax would have been had the crude oil been sold at its adjusted base price.⁸⁷ The severance tax adjustment is allowed for the amount by which the actual severance tax exceeds the severance tax that would have been imposed had the crude oil been sold at its adjusted base price. Once the severance tax adjustment is calculated, that figure is subtracted from the adjusted base price to determine the gross amount of windfall profit subject to taxation.⁸⁸

D. Net Income Limitation

As a general rule, the windfall profit on any barrel of crude oil will be the excess of the removal or sales price over the sum of the adjusted base price and the severance tax adjustment.⁸⁹ Notwithstanding the foregoing, the windfall profit on any given barrel of crude oil may not exceed ninety percent of the net income attributable to that barrel.⁹⁰ Net income attributable to each barrel is the producer's taxable income from the property, as computed for percentage depletion purposes,⁹¹ divided by the number of barrels of

84. *Id.* § 4996(c)(2) (West 1980).

85. Treas. Reg. § 150.4996-2(b) (1980) (temporary regulation cited in 45 Fed. Reg. 23396 (1980)).

86. 26 U.S.C.A. § 4996(c)(3)(A) (West 1980).

87. *Id.* § 4966(c)(1).

88. *Id.* § 4988(a)(2).

89. *Id.*

90. *Id.* § 4988(b).

91. For this purpose, taxable income is determined by reference to 26 U.S.C. § 613 (1976). No deductions are permitted for depletion, the windfall profit tax, intan-

taxable crude oil produced from the property during the taxable year.⁹² For net income limitation purposes, the federal income tax definition of property is utilized, rather than the DOE definition.⁹³ Because the nature of the calculation is based on information possessed by the producer alone, the first purchaser does not consider the net income limitation in determining the amount to be withheld from the purchase price paid to the producer.⁹⁴ Instead, the producer determines whether the net income limitation applies and files a claim with the Internal Revenue Service for either a credit or a refund.⁹⁵ In those instances where producers deposit their own tax, however, the net income limitation may be taken into account to reduce the amount of the deposit.⁹⁶

E. 1980 Credit for Royalty Owners

During the latter stages of the Ninety-sixth Congress, legislation was enacted and signed by President Carter granting certain royalty owners a one-time credit against the windfall profit tax for the year 1980.⁹⁷ This legislation was enacted in response to demands for relief by small royalty owners who asserted that, relative to larger producers, they were bearing a disproportionate burden of the windfall profit tax. The legislation treats a sum of up to \$1,000 as an overpayment that is either to be credited against the tax or refunded to the taxpayer.⁹⁸ The credit or refund is applicable to crude oil removed from the premises during March 1, 1980 through December 31, 1980⁹⁹ that is attributable to a royalty owner's nonoperating mineral interest.¹⁰⁰ The credit or refund is avail-

gible drilling and development costs. 26 U.S.C.A. § 263(c) (West Cum. Supp. 1981). No deductions are permitted for qualified tertiary injectant expenses which the producer elects to capitalize. 26 U.S.C.A. § 4988(b)(3)(B)(iv) (West 1980).

92. See generally Treas. Reg. § 51.4988-2(b)(iii) (1981) (temporary regulation cited in 46 Fed. Reg. 1755 (1981)). Special rules were enacted with regard to production payments and the computation of taxable income dealing with certain transfers of proven oil and gas properties. 26 U.S.C.A. § 4988(b)(4)-(5) (West 1980).

93. Compare 26 U.S.C. § 613 (1976) with 10 C.F.R. § 212.72 (1980).

94. 26 U.S.C.A. § 4995(a)(2)(B) (West 1980).

95. Treas. Reg. § 150.6402-1 (1981) (temporary regulation cited in 46 Fed. Reg. 4886 (1981)). For a detailed discussion of the administrative provisions of the Act, see notes 102-124 *infra* and accompanying text.

96. Treas. Reg. § 150.4995-3 (1980) (temporary regulation cited in 45 Fed. Reg. 73,468 (1980)).

97. A provision for the credit is contained in § 1131 of the Omnibus Reconciliation Act of 1980, Pub. L. No. 96-499 § 1131, 94 Stat. 2599 (1980). The credit provision will be codified at 26 U.S.C. § 6429 (1976).

98. *Id.* § 6429(a)-(c)(1).

99. *Id.* § 6429(d)(2)(B), (d)(3).

100. *Id.* § 6429(d)(2)(A). This section refers to the term "operating mineral

able only to those producers¹⁰¹ who qualify as individuals, estates, or qualified family farm corporations.¹⁰² To the extent that a royalty owner takes the credit or refund, however, there is no overpayment deduction permitted for income tax purposes.¹⁰³

VII. ADMINISTRATION OF THE TAX

The Act imposes affirmative administrative responsibilities on three categories of persons: The producer; the operator; and the purchaser. The producer is the holder of the economic interest with respect to the crude oil in place in the ground.¹⁰⁴ The operator is the person primarily responsible for the management and operation of crude oil production on a property.¹⁰⁵ The term "purchaser" includes only the first person purchasing production of domestic crude oil.¹⁰⁶

The administrative responsibilities of persons in the three categories are interrelated and, in some circumstances, interchangeable. Thus, although the windfall profit tax is imposed on the producer, primary collection responsibility is placed on the first purchaser.¹⁰⁷ With the exception of specific instances provided for in the regulation,¹⁰⁸ the first purchaser is required to withhold an

interest" within the meaning of § 614(d) of the Code. See note 12 *supra* for a discussion of the distinction between working or operating interests and nonworking or nonoperating interests.

101. The Act defines "producers" in 26 U.S.C.A. § 4996(a)(1) (West 1980).

102. 26 U.S.C. § 6429(d)(1) (1976). A family farm corporation will qualify for the credit or refund if: (1) It was in existence on June 25, 1980; (2) all of the outstanding shares of stock were held by members of the same family, within the meaning of 26 U.S.C.A. § 2032A(e)(2) (West 1980), during the relevant period; and (3) 80% of the asset value, other than royalty interests, was held by the corporation for use for farming purposes, within the meaning of 26 U.S.C.A. § 2032A(e)(5) (West 1980).

103. *Id.* § 280D.

104. 26 U.S.C.A. § 4996(a)(1)(A) (West 1980); Treas. Reg. § 150.4996-1(b) (1980) (temporary regulation cited in 45 Fed. Reg. 23395 (1980)).

105. 26 U.S.C.A. § 4996(a)(2)(1980); Treas. Reg. § 150.4996-1(c) (1981) (temporary regulations cited in 46 Fed. Reg. 4882 (1981)).

106. Treas. Reg. § 150.4996-1(a) (1981), (temporary regulation cited in 46 Fed. Reg. 4882 (1981)).

107. See 26 U.S.C.A. § 4986(b) (West 1980); 26 U.S.C.A. § 4995(a)(1)(A) (1980).

108. The first purchaser is required to withhold the tax from amounts payable to the producer unless: The crude oil has been removed from the premises before it is sold; the conversion of crude oil into refined products begins before the oil is removed from the premises; the producer is an integrated oil company; another withholding agent is designated under the qualified disburser election; the United States is the producer of the crude oil which is removed after March 31, 1981 and the oil is sold directly to the first purchaser by the Department of the Interior; or a lessee or operator for the Department of the Interior furnishes a federal royalty certificate to the first purchaser reflecting that the United States is the producer. Treas. Reg. § 150.4995-1(a) (1981).

amount equal to the tax imposed from the amount payable to the producer,¹⁰⁹ to deposit the amount of the tax,¹¹⁰ and to file quarterly windfall profit tax returns.¹¹¹ If, however, the producer is an integrated oil company¹¹² or if one of the other exceptions apply,¹¹³ then the first purchaser does not withhold the tax and the producer assumes the specified obligations of the first purchaser.¹¹⁴ Moreover, the first purchaser and the operator may jointly elect to have the operator assume the first purchaser's responsibilities in this regard.¹¹⁵ The regulations provide an additional alternative entitled the "qualified disburser election," which permits a party other than the first purchaser to act as a withholding agent if that party is responsible for distributing the crude oil sales proceeds to the various producers with respect to a particular property.¹¹⁶

The administrative mechanisms of the Act are carried out by the purchaser, producer, and operator through a series of certified

109. 26 U.S.C.A. § 4995(a)(1)(A) (West 1980).

110. *Id.* § 4995(b)(2)(A), Treas. Reg. § 150.4995-3(c) (1981) (temporary regulation cited in 45 Fed. Reg. 4879-4880 (1981)).

111. *See* 26 U.S.C.A. § 4995(a)(6) (West 1980) 26 U.S.C.A. § 6076 (1980); Treas. Reg. § 150.4997-1 (1981); Treas. Reg. § 150.6076-1 (1981) (temporary regulation cited in 46 Fed. Reg. 4886 (1981)).

112. For windfall tax purposes, an integrated oil company means a taxpayer that is not a refiner as described in §§ 613A(d)(2) & (4) of the Code. 26 U.S.C.A. § 4995(b)(3) (West 1980).

113. *See* note 108 *supra*.

114. 26 U.S.C.A. § 4995(b)(1) (West 1980). An integrated oil company that is a producer is required to furnish the first purchaser with a certificate saying that the producer will deposit its own windfall profit tax liability and that there will be no withholding from the producer's share of the production. *See* Treas. Reg. § 150.4995-2(c)(2) (1981) (temporary regulation cited in 46 Fed. Reg. 4878 (1981)).

115. 26 U.S.C.A. § 4995(a)(7) (West 1980). The regulations provide that this election is available only when the operator already is required to make deposits as a purchaser of oil produced from a different oil reservoir. While the election is in effect the operator is treated as the purchaser for purposes of the Act. Treas. Reg. § 150.4995-4(a) (1981) (temporary regulation cited in 46 Fed. Reg. 4881 (1981)); Treas. Reg. § 150.4995-4(b) (1980) (temporary regulation cited in 45 Fed. Reg. 23395 (1980)).

116. Frequently, a person other than a first purchaser is responsible for distributing the sales proceeds of crude oil to the various producers pursuant to a division order. A division order is an agreement which typically is entered into after production has begun wherein the parties with interests in the production stipulate to the allocation of the proceeds and direct the operator to distribute these proceeds. Under the regulations, a "qualified disburser" is a person receiving payments from the sale of crude oil who is responsible for distributing 20% or more of the entire proceeds, exclusive of that person's own share of the proceeds, from the sale of oil from a property to one or more producers of the oil. To the extent that a "qualified disburser" elects to act as the withholding agent he shall be treated as the first purchaser under the Act. Treas. Reg. § 150.4995-5 (1981).

tax statements. The first purchaser or producer determines the amount of the tax to be withheld or deposited on the basis of a monthly certification furnished by the operator.¹¹⁷ Producers of independent producer oil may have the amount withheld to comport with their reduced tax rate or exempt tax status by providing a certification to the purchaser.¹¹⁸ The purchaser is entitled to rely on the certification in determining the amount to be withheld unless the certification has not been furnished or the purchaser has reason to believe that such information is not correct.¹¹⁹ In both instances, the purchaser deducts and withholds in accordance with the provisions of the regulations.¹²⁰ The Act precludes the first purchaser from taking the net income limitation into account in determining the amount to be withheld.¹²¹ Any error that is discovered with respect to the administrative withholding mechanism may be corrected by making adjustments in the amounts withheld from subsequent payments.¹²² When the error cannot be adjusted fully in the same calendar year, the producer must file a return and either pay the additional tax or claim a credit or refund.¹²³

In addition to the certified tax statements, the regulations require the purchaser to furnish a monthly statement to each producer or operator to whom the purchaser makes payment reflecting

117. See 26 U.S.C.A. § 4995(a)(2)(A)(i) (West 1980); 26 U.S.C.A. § 6050C (West 1980). The statement, which is signed under penalty of perjury, must certify, *inter alia*, the adjusted base price of the crude oil, the tier and category of the crude oil, and the amount of the crude oil. 26 U.S.C.A. § 6050C(a) (West 1980). See generally Treas. Reg. § 150.6050C-1 (1981) (temporary regulation cited in 46 Fed. Reg. 4885-4886 (1981), 45 Fed. Reg. 27,932 (1980), 45 Fed. Reg. 23,398 (1980)). Moreover, if the purchaser or producer has the information necessary to comply with the provisions of the Act, then the purchaser or producer may agree in writing to relieve the operator of the duty of furnishing some or all of the required information. 26 U.S.C.A. § 6050C(b) (West 1980), Treas. Reg. § 150.6050C-1(d) (1980) (temporary regulation cited in 45 Fed. Reg. 23398 (1980)).

118. With regard to producers' certification, see generally Treas. Reg. § 150.4995-2 (1980) (temporary regulation cited in 46 Fed. Reg. 4877-4879 (1981), 45 Fed. Reg. 27931 (1980), 45 Fed. Reg. 2393 (1980)). Copies of certifications are furnished to the purchaser by the operator as a part of the monthly certification. 26 U.S.C. § 6050C(a)(3) (1976).

119. 26 U.S.C.A. § 4995(a)(2)(A) (West 1980).

120. Treas. Reg. § 150.4995-1(b) (1980) (temporary regulation cited in 46 Fed. Reg. 4876 (1981), 45 Fed. Reg. 23391 (1980)).

121. 26 U.S.C.A. § 4995(a)(2)(B) (West 1980). The regulations, however, provide that the net income limitation may be taken into account in those situations where producers deposit their own liability. Treas. Reg. § 150.4995-3(a) & (f)-(g) (1980).

122. 26 U.S.C.A. § 4995(a)(3) (West 1980), Treas. Reg. § 150.4995-1(c) (1980) (temporary regulation cited in 46 Fed. Reg. 4876-4877 (1981), 45 Fed. Reg. 23391-23392 (1980)).

123. *Id.*

the amount of tax that has been withheld.¹²⁴ The regulations provide that every purchaser who is required to deduct and withhold tax is liable for the tax required to be withheld. This liability attaches regardless of whether the tax actually is withheld. To the extent that the purchaser assumes the producer's tax liability, however, the producer is accountable to the purchaser.

VIII. ENFORCEMENT

The provisions of the Crude Oil Windfall Profit Tax Act of 1980 are incorporated specifically into the various civil and criminal enforcement provisions of the Internal Revenue Code.¹²⁵ The Treasury Department, therefore, has available to it the full range of enforcement tools that it employs in the assessment, collection, and prosecution of the federal income, estate, and gift taxes. The single notable addition provided by the Act is the imposition of criminal sanctions against operators who willfully fail to furnish information to purchasers regarding the amount of tax to be withheld.¹²⁶

The crude oil producer who is subject to windfall profit taxation has the same alternatives for redress that are available to other federal taxpayers. Litigation may be commenced either by contesting a deficiency assessment or by filing suit for a refund. Upon the assessment of a deficiency, a producer may petition the United States Tax Court for a redetermination of the deficiency.¹²⁷ The Tax Court does not provide a right to trial by jury, and any appeal of a Tax Court determination may be taken only to the United States court of appeals for the circuit in which the producer resides or to a circuit agreed to by the stipulation of the parties.¹²⁸ A producer who does not file a timely Tax Court petition, pays the deficiency before receipt of notice thereof, or claims a refund, may file suit in an appropriate United States district court or the Court of Claims.¹²⁹ There is no right to trial by jury in the Court of Claims, and appellate review of its decisions may be sought only by filing a

124. Treas. Reg. § 150.4997-2 (1981) (temporary regulation cited in 46 Fed. Reg. 4884-4885 (1981)).

125. 26 U.S.C.A. § 4998 (West 1980); 26 U.S.C. §§ 6050C, 7241 (1976).

126. 26 U.S.C. § 7241 (West Cum. Supp. 1981). A person found guilty of violating this section is guilty of a misdemeanor and may be subject to a fine not exceeding \$10,000, imprisonment for not more than one year, or both. *Id.*

127. *Id.* §§ 6213, 7442.

128. *Id.* §§ 7444(c), 7482(b).

129. *Id.* § 7422.

petition for certiorari in the United States Supreme Court.¹³⁰ The tax in most instances will be paid in advance as a result of the withholding and depositing procedures established by the Act, so a substantial portion of the litigation relating to the Act is likely to originate in federal district courts in the form of suits for refund of overpayments.¹³¹

IX. PHASEOUT OF THE TAX

The windfall profit tax is scheduled to be phased out at the end of a thirty-three month period¹³² beginning January 1, 1988 or the month the United States Treasury has received aggregate net revenues of \$227.3 billion,¹³³ whichever occurs later. In no event will this period begin later than January 1991.¹³⁴ During the thirty-three month phaseout period a producer's windfall profit tax liability will decrease by three percent each month.¹³⁵ Therefore, the tax will expire at some time between October 1990 and October 1993.

X. CONCLUSION

Those practitioners who have clients in the oil industry and those who have responsibilities relating to the production, purchase, or sale of crude oil have devoted countless hours to the task of analyzing the extraordinarily complex Crude Oil Windfall Profit Tax of 1980. Even though the Act has been in effect for only one year, regulations clarifying and implementing its provisions issue from the Treasury Department with unrelenting frequency. The enormous costs of analyzing, administering, and complying with the tax are burdensome. While the decontrol of crude oil prices has relieved at least part of this burden, some producers have suggested that the legislation should be repealed in its entirety. Despite the fervent hopes that crude oil producers have regarding the early repeal of the windfall profit tax, however, it seems likely that the Act will be with us for the foreseeable future.

130. *Id.* See also 28 U.S.C. §§ 171-175, 1491 (1976).

131. At least one lawsuit has been filed challenging the constitutionality of the windfall profit tax. *Independent Petroleum Ass'n. of America v. United States*, No. 80-0302 (D. Wyo. 1980). The primary ground asserted is that since the tax is not imposed in a geographically uniform manner, it constitutes an illegal excise tax.

132. 26 U.S.C.A. § 4990(c) (West 1980).

133. In computing its estimates of aggregate net revenues, the Treasury Department must take into account the decrease in tax revenues resulting from the deductibility of the windfall profit tax. *Id.* § 4990(d)(3).

134. *Id.* § 4990(c) (1980).

135. *Id.* § 4990(c)(2).