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EVOLUTION OF THE CRUDE OIL WINDFALL PROFIT TAX—AN EXAMINATION OF RECENT CHANGES

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I. INTRODUCTION

This article will examine two major recent developments affecting the crude oil windfall profit tax, the Economic Recovery Tax Act of 1981[1] and the adoption of the final treasury regulations relating to the "net income limitation."[2] The tax is only examined from the standpoint of producers, and discussion of the administrative aspects of the law as it relates to withholding parties is generally excluded. To aid in understanding the new developments, a few of the more important basic provisions of the law will be reviewed first.[3]

II. BASICS OF THE WINDFALL PROFIT TAX

The windfall profit tax is an excise tax[4] and not a tax on "prof-

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1. Pub. L. No. 97-34, 95 Stat. 172 (1981).

2. *See* Treas. Reg. § 51-4988-2, *reprinted in* 1982 STAND. FED. TAX REP. (CCH) ¶ 4974E.

3. *See generally* Miller & Easley, *The Windfall Profit Tax—An Overview*, 12 ST. MARY'S L.J. 414 (1980); *The Crude Oil Windfall Profit Tax Panel Discussion*, SW. LEGAL FOUNDATION 32ND INST. ON OIL & GAS LAW & TAX. 437 (1981).

4. *See* I.R.C. § 4896(a). An "excise tax" has been defined as a "tax laid only upon the

its" or taxable income as described by the Internal Revenue Code.[5] As an excise tax, the relative profitability or, more importantly, the taxable income of the producer, bears no direct relationship to the amount of the tax. The tax depends, rather, upon the windfall profit tax classification of the type of the oil (its "tier"), the windfall profit tax designation of the type of producer, and the selling price of the oil.

A. *Type of Oil—Tier Classification*

Three classifications or "tiers" of taxable crude oil were created under the Crude Oil Windfall Profit Tax Act of 1980.[6] Tier 1 oil is literally defined as any taxable crude oil other than Tier 2 or Tier 3 oil.[7] Tier 2 oil is oil produced from a "stripper" property (or from the National Petroleum Reserve)[8] while Tier 3 oil is "newly discovered" oil (basically, oil produced from a property from which there was no production in 1978),[9] "heavy oil,"[10] or "incremental tertiary" oil.[11] Tier 1 oil, then is principally oil produced from a property which was in production during 1978 and which could not be otherwise classified as Tier 2 or Tier 3.

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exercise of a single one of those powers incident to ownership." Bromely v. McCaughn, 280 U.S. 124, 136 (1929); *see* Mount Livy Winery, Inc. v. Lewis, 134 F.2d 120, 124 (9th Cir. 1943). The Windfall Profit Tax is, therefore, essentially a tax upon the exercise of the right to sell crude oil in excess of the adjusted base price. *See* I.R.C. § 4988 (West 1980).

5. Profits are, of course, taxed as income. *See* I.R.C. § 63 (Supp. III 1979).

6. I.R.C. §§ 4991(c)-(e) (West 1980).

7. *Id.* § 4991(c).

8. *Id.* § 4991(d)(1). Tier 2 oil, however, does not include tier 3 oil. *See id.* § 4991(d)(2). "Stripper" well property is defined as "a property whose average daily production of crude oil (excluding condensate recovered in non-associated production) per well did not exceed 10 barrels per day during any preceding consecutive 12-month period beginning after December 31, 1972." 10 C.F.R. § 212.54 (1981).

9. I.R.C. § 4991(e)(1)(A) (West 1980). "Newly discovered oil" means, after December 1980, oil produced from a new lease on the Outer Continental Shelf or from property from which no crude oil was produced and sold in commercial quantities in calendar year 1978. 10 C.F.R. § 212.79(b) (1981).

10. I.R.C. § 4991(e)(3) (West 1980).

11. *Id.* § 4993(a). Incremental tertiary oil is, essentially, oil produced in excess of a "base level." *Id.* § 4993(a). The "base level" equals the average monthly production for the period from October 1, 1978 to March 31, 1979, less 1% of the average monthly production for the sixth-month period in each month beginning after 1978, up to and including the month in which the project begins. This is further reduced by 2-1/2% of the average monthly production for the six-month period in each month after the project starting date excluding the month for which the base level is being computed. *Id.* § 4993(b)(1).

B. *Type of Producer*

The tax is imposed upon the "producer" of the crude oil.[12] The producer, however, is defined as anyone possessing an economic interest in the oil, and thus includes royalty owners as well as working interest owners.[13]

There were five very narrowly defined categories of oil exempt from windfall profit taxes under the original law.[14] These exemptions were either granted on the type of oil, the location of production, or the type of producer. The exemption included oil produced from certain areas of Alaska,[15] oil produced from specified enhanced recovery projects,[16] and oil produced from certain properties held by Indians,[17] state and local governments,[18] and medical and educational charities.[19]

C. *Selling Price*

The windfall profit tax is computed on each barrel of taxable crude oil removed from the premises.[20] The tax is imposed upon that portion of the gross selling price of the oil which has been computed as the windfall profit. The windfall profit is the selling or removal price less a base price adjusted for inflation and severance taxes.[21] The base price is an amount which basically equates

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12. *Id.* § 4986(b).

13. *See* Treas. Reg. § 150.4996-1(b), *reprinted in* 1982 STAND. FED. TAX REP. (CCH) ¶ 4982B.

14. *See* I.R.C. § 4991(b) (West 1980).

15. *Id.* §§ 4991(b)(3), 4994(e).

16. *Id.* §§ 4991(b)(4), 4994(c); *see* 10 C.F.R. § 212.78(a).

17. I.R.C. §§ 4991(b)(2), 4994(d) (West 1980).

18. *Id.* §§ 4991(b)(1), 4994(a).

19. *Id.* §§ 4991(b)(1), 4994(b).

20. *Id.* § 4987(a), 4988(a).

21. *Id.* § 4988(a). Tier 1 oil is taxed at 50% of the windfall profit for independent producers and 70% for all other producers. *Id.* § 4987(b)(1)-(2). An "independent producer" is, essentially, one who is not an oil or gas retailer or oil refiner. *Id.* § 4992(b). Independent producer oil may not exceed 1,000 barrels per day each quarter. *Id.* § 4992(c)(1). The excess is allocated, proportionately, to Tier 1 and Tier 2 oil based on respective production during the quarter. *Id.* § 4992(c)(2). Tier 2 oil is taxed at 30% of the windfall profit for independent producers and 60% for all other producers. *Id.* § 4987(b)(1)-(2).

Under the new law, Tier 3 non-newly discovered oil is taxed at 30% of the windfall profit. *Id.* § 4987(b)(3) (West Supp. 1982). Tier 3 newly discovered oil is taxed at 27-½%, reduced incrementally to 15% in 1986 and thereafter. *Id.* § 4987(b)(3). Under the original law, all Tier 3 oil was taxed at 30%. *See* P.L. 96-223, Title I, § 101(a)(1), 94 Stat. 230 (1980).

to a May or December 1979 (depending on the tier of the oil) selling price for oil from that property, with certain adjustments.[22] The severance tax adjustment is simply the difference between the selling or removal price and the adjusted base price, multiplied by the appropriate state severance tax rate (provided the state severance tax rate is expressed as a percent of value).[23]

The taxable windfall profit associated with any barrel is limited to 90% of the net income attributable to such barrel.[24] This provision is commonly known as the "net income limitation." Net income is examined in more detail later, but, in general, it is determined in the same manner, except for a few important adjustments, and for the same properties as is the limitation on the depletion calculations for federal income tax purposes. Some of the adjustments include the disallowance of deductions for intangible drilling and development costs and windfall profit taxes and the creation of a special deduction for cost depletion. Although the windfall profit is subject to the net income limitation noted above, the party that withholds the taxes cannot take another producer's net income limitation into account when withholding.[25] Thus, producers with a net income limitation smaller than the windfall profit on a barrel must apply for a refund of over withheld taxes

22. I.R.C. §§ 4988(a)(1), 4989(a)-(d) (West 1980).

23. *Id.* §§ 4988(a)(2), 4996(c). Severance taxes adjustments are limited to a 15% ceiling. *Id.* § 4996(c)(3)(A).

24. *Id.* § 4998(b)(1) . Net income attributable to each barrel is the taxable income (as described for windfall profit tax purposes) from the property for the taxable year attributable to taxable crude oil divided by the number of barrels of taxable crude oil taken into account for that taxable year. *Id.* § 4988(b)(2)(A)-(B).

25. *See id.* § 4995(a)(2)(B). The Code requires the purchaser to withhold an amount equal to the Windfall Profit Tax from payments made to the producer. *See id.* § 4995(a)(1). For example, assume a selling price of $35.00 per barrel, an adjusted base price of $15.00, and a severance tax of $1.00. The windfall profit is $19.00. If this windfall profit is taxed at 70%, the first purchaser will withhold $13.30 in windfall profit tax. *Id.* § 4995(a)(2)(B). Assume further that the producer has a net income on this barrel of $15.00. The windfall profit may not exceed 90% of the net income. *Id.* § 4988(b)(1). Ninety percent of $15.00 equals $13.50. The producer's windfall profit tax liability, therefore, is reduced to 70% of $13.50, or $9.45, and the producer may file for a refund to the extent that the first purchaser's withholding ($13.30) exceeded the actual liability of the producer ($9.45). There are two problems with this arrangement. First, the net income limitation of other producers may not be taken into account by the first purchaser when calculating the windfall profit tax to be withheld. *Id.* § 4995(a)(2)(B). Secondly, no refunds may be made until the end of the taxable year. *Id.* § 4995(a)(8)(B). Thus, if the tax is withheld in January, the producer must wait over one year before filing for a refund. *Id.* § 4995(a)(8)(B).

well after they have been withheld.

With these oversimplified basics in mind, an examination will now be made of the recent changes.

III. The Economic Recovery Tax Act of 1981

Contained in the massive legislation encompassed by the Economic Recovery Tax Act of 1981 were several provisions dealing with windfall profit taxes. These provisions should provide substantial benefits to oil producers in the future. The changes are aimed at both royalty owners and working interests and will benefit independent producers, as well as integrated oil companies. Of course, not all benefits apply to each producer.

Royalty owners will obtain relief in three ways, though not all at once. First, the $1,000 credit provided for 1980 production for individuals, estates, and qualified family farm corporations has been increased to $2,500 and extended to include 1981 production.[26] Section 6429, controlling the application of this credit, basically mirrors the rules governing 1980's $1,000 credit with certain exceptions, most of which are aimed at limiting the availability of the credit on transfers of property. Royalty production available for the credit will not include production attributable to an overriding royalty interest;[27] a production payment,[28] a net profits interest,[29] or similar interest created out of an operating interest in a proven property after June 9, 1981, unless a binding contract for this purpose existed at or before June 10, 1981.[30] This rule will not limit a landowner's ability to retain a royalty on a leasing transaction involving *unproven* properties. Section 6429(d)(3)(A) specifies that production attributable to any interest as a proven property transferred after June 9, 1981, will not be eligible for the credit.[31] It

26. *See id.* § 6429 (West Supp. 1982). Payment, by qualified royalty owners, of the Windfall Profit Tax on qualified royalty production in calendar year 1981 is treated as an "overpayment" to the extent that it does not exceed $2,500.00. *Id.* § 6429(c)(1). Note, however, that special rules exist for fiscal year taxpayers whose overpayments are due to the net income limitation. *See* Temp. Treas. Reg. § 150.6402-1(c)(2), *reprinted in* 1982 Stand. Fed. Tax Rep. ¶ 5404D.

27. I.R.C. § 6429(d)(2).

28. *Id.* § 6429(d)(2).

29. *Id.* § 6429(d)(2).

30. *Id.* § 6429(d)(2)(A)-(B).

31. *See id.* § 6429(d)(3)(A).

should be noted, however, that there are exceptions to this transfer rule which are similar to those provided for percentage depletion purposes under section 613A(c)(9).[32] That is, the credit will not be disallowed on transfers at death, certain changes in beneficiaries of estates or trusts, and the like. Note also that none of the new transfer rules apply to transfers of unproven property.

Beginning with production in calendar year 1982, the royalty owner's credit will be replaced by a royalty owner's exemption.[33] This benefit is limited by the same transfer rules as the royalty owner's credit and, again, is only available to individuals, estates, and qualified family farm corporations.

The royalty owner's exemption will be applied as follows. A "royalty limit" is established for each calendar quarter by multiplying the number of days in such quarter by the limitation in barrels.[34] For 1982 through 1984, this limit is two barrels; for 1985 and thereafter the limit will be three barrels.[35] Although commonly referred to as a "two (or three) barrels a day" exemption, such phraseology is not technically accurate. The royalty limit is determined and applied on a *quarterly* basis. Consider the situation of a royalty owner whose production commences June 5, 1982, and averages seven barrels a day. His total production for the second quarter of 1982 will be 182 barrels (26 days of production in June times seven barrels a day). This amount also coincidentally represents his royalty limit for such quarter, determined as follows:

April	30	days
May	31	days
June	30	days
	91	
	x 2	barrels
	182	barrels royalty limit

If the limit were applied on a per-day basis he would be able to exempt only 52 barrels of his production. There are no provisions in the law which state that the exemption only applies to barrels

32. *See id.* § 6429(d)(3)(A).
33. *Id.* § 4994(f).
34. *Id.* § 4994(f)(2)(A).
35. *Id.* § 4994(f)(2)(A).

produced after date of acquisition or date of first production. To be sure, this distinction is only critical in the quarter of the first production or acquisition, and will apply to only a few barrels of production. Care should be taken, however, not to lose any of this valuable benefit.

The producer in the above example faces another, perhaps more serious, problem. A royalty owner may, by certification, notify the first purchaser to refrain from withholding windfall profit taxes on a specified property. If the production from that property (or a combination of properties) exceeds two barrels *a day*, however, the property (or properties) may not be so certified. If the property in our example continued to average seven barrels a day production, the producer could not certify the property. The first purchaser would, therefore, withhold the windfall profit tax for all seven barrels and the producer would have to wait until March of the next year to claim a refund for taxes withheld on the two barrels per day of "exempt" oil.[36] The benefits of having the current use of money are obvious.

Producers with several properties averaging less than the specified per day limit should take care in choosing which properties to certify for exemption. The level of benefit derived from the exemption will depend directly on the windfall profit tax tier of the oil which has been produced. Naturally the tax savings from exempting two barrels of Tier 1 oil (taxed at 70%) will exceed those obtained from exempting two barrels a day of Tier 3 oil (taxed at 30%). If, however, a producer has a Tier 1 property which averages five barrels a day production and a Tier 3 property which averages two barrels a day production, as noted above, he may not exempt the Tier 1 production from taxation. Does this mean that our producer must certify a property that will yield less than the maximum benefit? No; the producer may instead choose not to certify a property at all and file a claim for refund after February of the next year.[37] Note, however, that if a producer does elect to certify a qualified property and if his royalty limit is entirely consumed by this property, he may possibly be precluded from later, after the

36. *See* INTERNAL REVENUE SERVICE, FORM 6783—QUALIFIED ROYALTY OWNER'S EXEMPTION CERTIFICATE.

37. *See* I.R.C. § 4995(a)(8) (West 1980); FORM 6783—QUALIFIED ROYALTY OWNERS EXEMPTION CERTIFICATE.

fact, determining that the exemption would have been better applied on a different property and filing a claim for refund for the difference. It is unclear at this time whether a producer could take such an action or, if he could, instead decertify a property at some point during the year and certify another, more attractive property. There does not appear to be anything in the law which would preclude such actions.

Finally, in choosing which properties to certify, the producer should be aware of the potential impact of the net income limitation. He would probably not want to certify a property on which there is likely to be a refund due to the net income limitation if there are others on which the limitation will apply.

The third benefit to royalty owners derives from the planned reduction in the rate of taxation of the portion of Tier 3 oil designated as "newly discovered" oil.[38] This reduction in rates, moreover, will apply to *all* producers, including integrated oil companies. The reduction in rates from 30% is scheduled to occur as follows:[39]

For Taxable Periods Beginning In	The Applicable Percentage Is
1982	27-1/2
1983	25
1984	22-1/2
1985	20
1986 and thereafter	15

Beginning in 1983, certain production from stripper properties will be exempt from windfall profit taxation.[40] The requirements for realizing this benefit are as follows:

1. the producer must be an independent producer;
2. the production must be attributable to a *working interest* in a stripper property; and
3. the production must not be from an interest in any property which at any time after July 22, 1981, was owned by a "non-independent" producer.[41]

38. *See id.* § 4987(b)(3)(B) (West Supp. 1982).
39. *Id.* § 4987(b)(3)(B).
40. *Id.* § 4991(b)(6); *see id.* § 4994(g).
41. *Id.* § 4994(g).

An "independent producer" is defined for windfall profit tax purposes as any producer who does not engage, either directly or through a related person, in retailing or refining activities above specified levels ($1,250,000 in retail sales in a calendar quarter or 50,000 barrels a day refinery throughput), and may include royalty owners as well as working interest owners.[42] A "non-independent" producer, then, is generally a producer which engages in retailing and refining activities above these levels.

There are several important aspects of the stripper exemption which should be considered. First, there is no quantity limitation on the barrels subject to exemption.[43] Thus, an independent producer may have more than 1,000 barrels a day of stripper production and have all of this production subject to exemption.[44] This is different from the rules governing the lower rate of windfall profit taxation on certain barrels of independent producer production and from those rules governing the availability of percentage depletion. Independent producers are allowed a lower rate on working interest production up to 1,000 barrels a day on Tier 1 and Tier 2 oil.[45] Any production in excess of this amount will be taxed at the higher non-independent producer rates.[46] Similar rules apply to the computation of percentage depletion, for which a 1,000 barrels per day of production limitation exists.[47]

Second, the transfer rule (requirement no. 3 above) only applies to transfers from non-independent producers.[48] Independent producers can buy and sell or otherwise exchange properties freely among themselves and not lose the stripper exemption. Remember, however, that percentage depletion could easily be lost in a transfer of a proven property.[49]

Finally, the stripper oil which is exempt from taxation does not reduce the 1,000 barrels a day which are eligible for lower rates of windfall profit taxes.[50] Therefore, an independent producer with

42. *Id.* § 4992(b) (West 1980).
43. *Id.* § 4994(g)(1) (West Supp.1982).
44. *See id.* § 4994(g).
45. *Id.* § 4992(c) (West 1980).
46. *Id.* § 4987(b).
47. *See id.* § 613A (1976 & Supp. III 1979).
48. *See id.* § 4994(g)(1)(A) (West Supp. 1982).
49. *See id.* § 613A(c)(9) (1976).
50. *See id.* § 4992(c)(2)(B) (West Supp. 1982).

1,000 barrels a day of Tier 1 production and 1,000 barrels a day of stripper production, which is eligible for the stripper well property exemption, may certify all of the Tier 1 production for the lower rates. Any stripper production which is ineligible for exemption, however, will be treated and taxed as regular Tier 2 oil. Obviously, the stripper well exemption is potentially a significant benefit to independent producers.

Tax planners should be alert for *any* opportunity to structure transactions which will result in obtaining working interests in stripper properties by independent producers, rather than royalty interests. This planning should include consideration of the advisability of retaining working interests in leasing or subleasing activities instead of royalties, subject, of course, to the economics of future property operations.

IV. Calculation of the Net Income Limitation Under the Final Regulations

The final regulations on the net income limitation were issued in late October, 1981.[51] These regulations contain many welcome and useful provisions as well as a few that may prove troublesome.

One of the more important—and sensible—changes allows taxpayers to make the necessary computations according to the method of accounting otherwise used for tax purposes.[52] Thus, a producer on the cash receipts and disbursements method of accounting no longer has to adopt a modified accrual method of net income limitation calculations as was prescribed by the proposed regulations.[53] Under the latter method, all taxpayers made compu-

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51. *See* Treas. Reg. § 51-4988-2, *reprinted in* 1982 Stand. Fed. Tax Rep. (CCH) ¶ 4974E.

52. *See id.* § 51-4988-2(b)(1)(i)-(iii).

53. Prop. Treas. Reg. § 51.4988(b)(1)(i)-(iii), *reprinted in* Fed. Taxes, Excise Taxes (P-H) ¶ 191,616. The proposed regulation provided:

> (b) Calculation of net income limitation—(1) In general. The net income limitation with respect to a barrel shall be computed in the following manner.
>
> (i) Determine the taxpayer's gross income from the property (from which the barrel was produced), pursuant to paragraph (b)(2) of this section, that is attributable to taxable crude oil removed from the premises during the taxable year (or during a previous taxable year, if the gross income therefrom was received or accrued during the current taxable year more than 2 months after the close of the taxable year of removal);
>
> (ii) Determine the taxpayer's taxable income from the property for the taxable

tations based on income and costs attributable to production during the taxable year. Revenues and expenses, including those received or paid in the first two months of the next taxable year (the so-called "two-month" rule), were matched with the production to which they related. Cash basis taxpayers, therefore, had to keep two sets of books, a modified accrual set for net income limitation purposes and their regular cash receipts and disbursements books for all other purposes.

The above noted change will create some problems with the use of Form 6248, *Annual Report of Windfall Profit Taxes*. This report is the starting point for many producers' net income limitation calculations and must be attached to any claim for refund of overpaid windfall profit taxes. This report presents barrels, removal values, windfall profit taxes withheld, etc., relative to the production in a calendar year. Futhermore, first purchasers are allowed to make adjustments in withholding up until such time as the Form 6248 is issued (which is several months after the close of the calendar year of production).[54] Therefore, all adjustments made prior to such issuance, including those made in the current tax year for the prior tax year, will be reflected on the report. It follows that the Form 6248 may or may not reflect the production

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year by reducing the gross income from the property determined under subdivision (i) by all amounts—

(A) That would be subtracted in determining taxable income from the property under section 613(a) (except depletion windfall profit tax, section 263(c) costs, and qualified tertiary injectant expenses to which an election under section 4988(b)(3)(E) applies),

(B) That are paid or incurred before the end of the period ending 2 months after the close of the taxable year, and

(C) That are attributable to the production of taxable crude oil removed from the premises during the taxable year (or during a previous taxable year, if the amounts were paid or incurred during the current taxable year more than 2 months after the close of the taxable year of removal),

and by the cost depletion deduction (described in paragraph (b)(4)) allowable for the taxable year.

(iii) Determine the taxpayer's net income attributable to each barrel of taxable crude oil removed during the taxable year by dividing the taxable income from the property determined under subdivision (ii) by the number of barrels in the taxpayer's share of taxable crue oil removed from the premises of that property during the taxable year.

(iv) Determine the net income limitation per barrel by multiplying the net income attributable to a barrel by 90 percent and rounding to the nearest cent.

Id. § 51.4988-2(b)(1)(i)-(iii).

54. *See* Temp. Treas. Reg. § 150.4995-1(c)(1)(ii) (1980).

upon which the taxpayer is making his calculations, depending upon his method of accounting.

A unique problem exists for cash basis taxpayers who filed claims for refunds due to the net income limitation under the proposed regulations. The final regulations provide that such calculations do not have to be revised.[55] It is unclear at this time whether such producers will have to exclude the barrels, revenues, expenses, and windfall profit taxes attributable to 1980 production for which payment was received in 1981 from their calculations.

Another change in the net income limitation calculations involves the method of allocating expenses on properties when taxable oil is produced in conjunction with either gas or exempt oil.[56] Formerly, under the proposed regulations, *all* expenses incurred in such production were allocated between oil and the other product based on relative gross income.[57] This sometimes produced the unusual effect of allocating expenses which could be directly associated with one type of production, such as severance taxes, to the other production. Consider the following example for a Texas property producing both oil and gas:

	Oil		Gas		Total	
Gross revenues	$10,000	(50%)	$10,000	(50%)	$20,000	(100%)
Production tax rate	x 4.6%		7.5%		N/A	
Actual production tax	460		750		1,210	
Production taxes allocated according to gross income	$ 605	(50%)	$ 605	(50%)	$ 1,210	(100%)

Although conceptually sound, this provision of the final regulations will cause problems for the many producers who do not maintain

55. *See* Treas. Reg. § 51.4988-2(c)(6), *reprinted in* 1982 STAND. FED. TAX REP. (CCH) ¶ 4974E.

56. *See id.* at § 51.4988-2(b)(2).

57. Prop. Treas. Reg. § 51.4988-2(b)(3), *reprinted in* FED. TAXES, EXCISE TAXES (P-H) ¶ 191,616 provided:

> (3) Attribution of expenses to gas or exempt oil. In the case where both taxable crude oil and gas or exempt oil is produced from the property, the amount of the expenditures to the production of gas or exempt oil is computed by multiplying the aggregate expenses incurred with respect to the property (as determined under paragraph (b)(1)(iii) by a fraction the numberator of which is the amount of the gross income from the property that is attributable to gas or exempt oil and the denominator of which is the total gross income from the property.

separate accounts reflecting expenses applicable to either oil or gas production.

Yet another change in the calculation of the net income limitation revolves around production centered in partnerships. The proposed regulations stated that the partner was the producer and that the net income limitation would be computed separately for each partner.[58] In many cases, this was understood to mean that the partnership would supply information so that the partner could calculate the net income limitation based upon his tax year and method of accounting. The final regulations, while not changing the rule that the partner is the producer, state that the net income limitation is to be calculated on the partnership's tax year and method of accounting.[59] The final regulations also provide that special allocations of income and expense will be recognized in these calculations.[60]

A question arises as to how to treat expenses outside the partnership which nonetheless pertain to the partnership. For instance, investors may be limited partners in a large number of limited partnerships and may incur substantial overhead related to these investments. How is this overhead to be treated? A clue may be provided by the wording of the final regulations:

> *In any case* in which a partnership computes the net income limitation for any partner, the partnership shall maintain in its books and records any information and documents bearing on the accuracy of its net income limitation computation so long as they are relevant in connection with the administration of any internal revenue law.[61]

The words "in any case in which a partnership computes the net income limitation for any partner" imply that there are situations contemplated in which the partnerships may not make the entire calculation for the partner. This wording may be indirect reference to situations such as the one noted above.

58. *See id.* § 51.4988-2(c)(3). The proposed regulation provided:

> Rule Applicable to Partnerships.
>
> In the case of a partnership, the net income limitation shall be computed separately for each partner.

Id. § 51.4988-2(c)(3).

59. *See* Treas. Reg. § 51.4988-2(c)(3), *reprinted in* 1982 STAND. FED. TAX REP. (CCH) ¶ 4974E.

60. *See id.* § 51.4988-2(c)(3).

61. *Id.* § 51.4988-2(c)(3) (emphasis added).

A slight change has been provided in the final regulations regarding the hypothetical or imputed cost depletion deduction.[62] The proposed regulations provided a method of calculating this deduction which, in many cases, was impossible to follow. Basically, the regulations stated that producers had to make the calculations on a basis determined as though cost depletion had been taken since the time the taxpayer acquired the property and as though he had capitalized intangible drilling and development costs.[63] Further, in arriving at the adjusted depletable basis at the beginning of the production period for which calculations were being made, producers were required to make pro forma calculations for prior years using the reserve estimates which existed in those prior years.[64] In other words, a producer was not allowed the benefit of hindsight, but was required to make calculations for a year based on the reserve estimates he would have had for that year—even

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62. *See id.* § 51.4988-2(b)(3).

63. Prop. Treas. Reg. § 51.4988-2(b)(4)(B)(ii)-(iii), *reprinted in* FED. TAXES, EXCISE TAXES (P-H) ¶ 191,616. The proposed regulations provided:

> (ii) The cost depletion deduction that would be allowable for the taxable year is computed by first determining the depletable basis of the oil property as of the date the taxpayer acquired an economic interest in the property. With regard to transfers of oil properties before 1979, the taxpayer's original basis in the property is determined under section 1012. The basis of proven oil or gas properties transferred after 1978 is determined under paragraph (c) of this section. A unit cost per barrel is then found by dividing the depletable basis by the estimated recoverable reserves determined for the year of acquisition for income tax purposes (whether or not the estimate later proves to be inaccurate). Adjustments to basis are then made for expenditures properly chargeable to capital account, section 263(c) costs, and qualified tertiary injectant expenses, to which an election under section 4988(b)(3)(E) applies, incurred during the year. A cost depletion allowance is determined for the taxable crude oil removed during that year and is subtracted from the depletable basis. The depletable basis minus the cost depletion allowance for that year is carried over to the next taxable year and the same computation is performed for each succeeding year until the current year.
>
> (iii) For purposes of computing the net income limitation, intangible drilling and development costs with respect to a nonproductive well shall be deducted from gross income from the property in the taxable year these costs are paid or incurred. However, section 263(c) costs with respect to a productive well may be deducted only as a part of the cost depletion deduction. If the taxpayer is unable to determine with reasonable certainty by the later of the end of the taxable year of the time the return is filed whether a well will be an oil well or gas well, the taxpayer shall treat the well as a gas well. If the well later proves to be an oil well (or a nonproductive well), the taxpayer may file an amended return or a claim for credit or refund.

Id. § 51.4988-2(b)(4)(B)(ii)-(iii).

64. *See* § 51.4988-2(b)(4)(ii).

though he knew that the reserve estimate was to be revised the next year.[65] Of course, many taxpayers, notably royalty owners, do not possess *any* reserve information, much less yearly changes in reserve estimates over a period of time. In addition, the proposed regulations set forth an unusually high level of substantiation requirements for these calculations, stating that the cost depletion deduction would be substantiated only if the best evidence available "clearly supports it."[66]

The final regulations relax these strict substantiation rules by removing the clear support requirement and requiring only a slightly less rigid "preponderance of evidence."[67] The final regulations, moreover, provide that the reserve estimates which are to be used initially are those which existed in the year of *first production* rather than the year of *acquisition*.[68] Discussion in the preamble to the final regulations provides evidence that the IRS is aware of the difficulty that many producers will have in making these calculations.[69] It is unclear, however, whether the above regulation changes will provide any real relief to producers without access to detailed reserve information. Many producers will still be forced to use current estimates and add back prior production to arrive at the reserves which existed at date of first production. If this is the best available evidence, then it would seem reasonable to make the calculation based on such information.

V. Conclusion

The final regulations on the net income limitation will not end the evolution of these complex calculations. Litigation, revenue rulings, and private letter rulings will continue to change and refine the process as long as there is a windfall profit tax.

The Economic Recovery Tax Act of 1981 contains provisions which should provide tangible relief to many producers. Almost since the day of its passage, though, legislation has been introduced into Congress which would reduce or completely eliminate

65. *Id.* § 51.4988-2(b)(4)(ii).

66. *See id.* § 51.4988-2(b)(4)(iv).

67. *See* Treas. Reg. § 51.4988-2(b)(3)(iii), *reprinted in* 1982 Stand. Fed. Tax. Rep. (CCH) ¶ 4974E.

68. *See id.* § 51.4988-2(b)(3)(ii).

69. *See* T.D. 7790, *reprinted in* 1981 Stand. Fed. Tax Rep. (CCH) ¶ 6825.

the exemptions, credits, and lower tax rates presented to producers through this bill.[70] It is one thing to pass a bill providing for a series of benefits occurring three, four, or five years in the future, but it is quite a different matter for those provisions to stand the passage of time unscathed.

The environment surrounding the crude oil windfall profit tax is one which is subject to constant change. Producers, and those involved in planning for producers, must stay abreast of the developments and be alert to the problems as well as the opportunities which are constantly arising.

70. *See, e.g.*, H.R. 4536, 97th Cong., 1st Sess. (1981); H.R. 4523, 97th Cong., 1st Sess. (1981); H.R. 4460, 97th Cong., 1st Sess. (1981).