State and Local Tax Alert: Substitute Oil and Gas Severance Tax Bill Passed by Ohio House

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On May 14, 2014, a substitute version of House Bill 375 (the Bill) was passed by the Ohio House of Representatives. The Bill contains several significant changes to the version of House Bill 375 that was first introduced in December 2013. If enacted, the Bill would make several significant changes to Ohio's existing oil and gas severance tax laws. The most significant proposed changes in the Bill are summarized in this alert.

Definition of 'Severer'

Under current law, "severer" is defined as "the person who actually removes natural resources from the soil or water of this state." The Bill would amend the definition of "severer" for purposes of the oil and gas severance tax to mean "the person that has the right to first sell severed oil or gas." This amendment would make non-severing working interest owners responsible for filing severance tax reports and paying the severance tax with respect to their oil and gas.

Severance Tax Rate and Tax Base

Summary of Current Law

Under current law, the severance tax rate for oil and gas severed through both horizontal and conventional wells is equal to 3 cents per MCF of natural gas severed and 20 cents per barrel of oil severed, which includes an administrative fee of .50 cents per MCF of natural gas and 10 cents per barrel of oil.

Under the Bill

Under the Bill, the administrative fee would be eliminated. The rates applied to conventional wells would be equal to 1.5 cents per MCF of gas severed and 10 cents per barrel of oil severed. For oil and gas severed from a horizontal well on or after October 1, 2014, the rate for both oil and gas would be 2.5% of the "wellhead gross receipts" from the first sale of that oil or gas.

“Wellhead gross receipts” is defined as “the total amount received by a severer or another person from the first sale of oil and gas, whether or not the sale occurs at the wellhead, after deduction for any fees paid or costs incurred or accrued by or on behalf of the severer or an affiliate of the severer for processing, gathering, transporting, fractionating, stabilizing, compressing, dehydrating, shrinkage, brokering, delivering, and market access for such oil and gas, but not including fees paid or costs incurred or accrued for oil and gas lease acquisitions, geophysical and geologic services, well site preparation, well drilling, well completion services, related tangible or intangible drilling costs, natural gas storage services, general merchandising, and lease operating costs for the production of oil and gas at the wellhead.” In other words, the tax would be based on the gross receipts attributable to what is severed at the wellhead, rather than gross receipts after value is added through midstream and downstream processes.

The Bill also would give the tax commissioner the ability to substitute another price if the commissioner establishes by a preponderance of the evidence that the first sale of oil or gas is between affiliates and is not comparable to other transactions in the Appalachian basin, or that the first sale is between non-affiliates and not conducted at an arm’s length. In such a case, the commissioner is required to apply the first applicable of the following:

- The price paid under the most comparable arm’s length contract or contracts to which the person paying the tax is a party for the sale of similar oil or gas from the same well or from a nearby well.
- The price paid under the most comparable arm’s length contract or contracts between other parties for the sale of similar oil or gas from a similar well.
- The posted price that is relevant in valuing similar oil or gas from a similar well.

Cost Recovery

Under the Bill, the first $10 million in wellhead gross receipts net of any payments to holders of royalty interests (i.e., the first $10 million after paying any royalties) from the first sale of oil or gas severed from a horizontal well the first day of production of which is on or after October 1, 2013 is exempt from the severance tax. For purposes of this exemption, “holder of a royalty interest” is defined to include any person authorized by a written agreement to share in the value or proceeds of a horizontal well’s production, except a person that has a working interest in the well. The reported purpose of this provision is to enable severers who have had a working horizontal well in production for less than a year before the effective date of the higher tax rate to achieve some cost recovery before their production is subject to the higher tax rates.

Payment of Horizontal Well Tax

Under current law, quarterly severance tax returns are required, and are due within 45 days after the last day of the quarter. The Bill extends this due date to 60 days after the last day of the quarter.

Personal Income Tax Credit, Severance Tax Credit and Commercial Activity Tax Exclusion

The Bill would provide for a non-refundable personal income tax credit for a taxpayer holding a fee holder's royalty interest in a well. The credit would be equal to the amount of oil and gas severance tax paid by the severer multiplied by the lesser of (i) 12.5%, or (ii) the proportion of the oil and gas severance tax by which the taxpayer's royalty payments are reduced or for which the taxpayer is contractually required to pay the severer. Taxpayers would not be permitted to carry forward unused credits. In addition, no taxpayer would be allowed, with respect to any well, to claim both the small business income tax deduction that was enacted in 2013 and the credit. To facilitate the administration of the credit, severers would be obligated to provide fee-holding royalty interest owners with written reports that list the amount of oil and gas severance tax the severer paid on old and gas severed and sold from a well.

The Bill also would provide for a non-refundable severance tax credit for the Commercial Activities Tax (CAT) paid by the severer with respect to taxable gross receipts realized from the first sale of oil or gas severed from a horizontal well. Taxpayers would not be permitted to carry forward unused credits.

Finally, for CAT purposes, the Bill would exclude gross receipts realized by a taxpayer that is a severer from the first sale of oil or gas severed on or after October 1, 2014, on the basis of which the taxpayer is subject to the severance tax on income from that sale, but only if the taxpayer is subject to the personal income tax, or if the taxpayer is a pass-through entity, only if the direct or indirect owners of the pass-through entity are subject to the personal income tax on the income from that sale. The prior version of the Bill had no such restrictions on the CAT exclusion.

The Bill now moves to the Senate. It is possible that the Senate will vote prior to its summer recess (reported to begin in early-to-mid June), but it also is possible that a vote will not come until later this year. Vorys will continue to track the progress of the Bill and will provide updates as appropriate. In the meantime, if you have any questions about any of the proposed amendments discussed in this Alert, please contact your Vorys attorney or Scott J. Ziance at sjziance@vorys.com or 614.464.8287; Chris L. Connelly at clconnelly@vorys.com or 614.464.8244; or John S. Petzinger at jspetzinger@vorys.com or 614.464.5696.