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State and Local Tax Alert: Substitute Severance Tax Bill Introduced

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On February 12, 2014, a substitute version of House Bill 375 (the Bill) was introduced in the Ohio General Assembly. The Bill proposes several significant changes to the version of House Bill 375 that was first introduced in December 2013, and 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.

Severance Tax Rate

Summary of Current Law

Under current law, the severance tax rate for oil and natural 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 0.50-cent per MCF of natural gas and 10 cents per barrel of oil.

Rate Under the Bill

Under the Bill, the administrative fee would be eliminated. The severance tax for both oil and gas would be calculated as follows:

Conventional Wells:

- First 3 years of production – no tax
- Years 4-20 – 0.25% of total gross receipts
- Year 21 forward – 0.10% of total gross receipts

Horizontal Wells:

- First 2 years of production – 1% of total gross receipts
- Years 3-20 – 2.25% of total gross receipts
- Year 21 forward – 1% of total gross receipts

For purposes of the above calculation, “total gross receipts” would include an owner’s gross receipts from the first sale of oil and gas severed, without deduction for costs incurred after the first point of sale. In addition, if the Tax Commissioner determines that the relationship between the owner and the first purchaser is such that the sale price is not indicative of the market price, the Tax Commissioner shall determine the market price and adjust the owner’s gross receipts on that basis of the Tax Commissioner’s determination of the market price. The Bill is silent regarding how these two determinations will be made.

This taxing scheme differs greatly from the previous version of the Bill, which would have taxed conventional wells in a similar manner to current law, and would have imposed a tax on oil and gas severed from horizontal wells of 1% of “net proceeds received” (i.e., net of certain post-production costs) for the first five years of production, and 2% thereafter.

Payment of Horizontal Well Tax

Under the Bill, the owner of the horizontal well would be responsible for reporting and paying severance tax on a quarterly basis in a similar manner as required under current law. Under the previous version of the Bill, however, an owner was able designate a severer to pay the severance tax on behalf of the owner, which would have allowed the severer to recoup the amount of taxes paid from the owner. The most recent version of the Bill removes that designation right.

Non-Refundable Personal Income Tax Credit and Commercial Activity Tax Exclusion

The Bill would provide for a non-refundable personal income tax credit for a taxpayer “directly holding” a fee holder’s royalty interest in a well. The credit would be the lesser of (i) 12.5% of the amount of oil and gas severance tax paid by the owner of the well, or (ii) or the proportion of the oil and gas severance tax that the taxpayer is “contractually required” to pay the owner. Taxpayers would not be permitted to carry forward unused credits. In addition, no taxpayer would be allowed to claim the credit in a year in which it also claims the small business income tax deduction that was enacted in 2013. The prior version of the Bill would have allowed a well owner a dollar-for-dollar personal income tax credit for oil and gas severance tax paid, and would have allowed the owner of a well to designate persons with a working interest or royalty interest in the well to claim the personal income tax credit, without the limitations set forth in the current version of the Bill. Finally, for CAT purposes, the Bill would exclude gross receipts realized from the first sale of oil or gas, 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.

Targeted Record-Keeping Extension

Only with respect to the oil and gas severance tax, the Bill would extend the taxpayer record-keeping requirement from four years to five years, a period that is longer than the taxpayer record-keeping requirement for CAT, sales and use tax, and personal income tax purposes. The prior version of the Bill contained no such extension.

Uncertainty Regarding Bill Co-Sponsor

On February 13, 2014, it was announced that a co-sponsor of the Bill, Rep. Peter Beck, would face additional felony charges in connection with alleged securities fraud. These additional indictments led to Rep. Beck's removal as chair of the House Ways & Means Committee. It is unclear how these indictments will affect the progress of the Bill.

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.