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The Windfall Profit Tax—Poor Tax Policy? Poor Energy Policy?

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The author discusses the Crude Oil Windfall Profit Tax Act of 1980, explaining the Act's component parts and its interrelationship with federal energy regulations. Analyzing the Act in relation to its purposes, the author concludes that the Act, although severely deficient in many areas, is a positive step toward achieving the nation's energy objectives.

I. INTRODUCTION

In April 1979, in the midst of the shortage of crude oil caused by cutbacks in Iranian production, President Carter announced that he would gradually decontrol domestic crude oil prices.[1] Under Carter's plan, decontrol would begin in June 1979 and continue at a fairly uniform rate over 28 months, ending October 1,

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1. The President's authority to decontrol oil prices arises from the Energy Policy and Conservation Act of 1979, which established mandatory price controls on domestic oil until June 1, 1979 and gave the President discretionary authority to continue price controls until October 1, 1981. 42 U.S.C. § 6201 (Supp. III 1979).

1981.[2] In conjunction with the phased decontrol program, the President proposed an excise or "windfall" profit tax on the oil company revenues generated by decontrol. Oil companies were expected to reap $1 trillion or more in the 1980's,[3] not only from decontrol, but also from future shortages and price hikes caused by the Organization of Petroleum Exporting Countries' cartel (OPEC).[4] Carter proposed a permanent excise tax of a flat fifty percent rate on the difference between the price at which each barrel of taxable oil is sold and its base price. Under the President's plan, there were three base prices: the controlled price of lower tier oil, the controlled price of upper tier oil, and, in the case of production of unregulated oil, the market incentive price.[5] Although Carter provided no relief for high-cost oil properties even when they fail to produce a profit, the plan did exempt Alaskan North Slope oil from the tax.[6] In addition, Carter proposed that the percentage depletion, which is calculated on gross revenue, be denied on that portion of the revenue representing the windfall profit.[7] Finally, Carter proposed that the revenues from the tax, estimated to be $295.9 billion during the 1980's,[8] go into an Energy Security Trust Fund to help the United States become independent of foreign oil. Specifically, this fund was to underwrite the construction of synthetic fuel plants, improve mass transit systems, and help the poor to bear the rising cost of energy.[9]

On March 27, 1980, less than a year after the Carter proposal, Congress passed the Crude Oil Windfall Profit Tax Act of 1980.[10] The Act differs from the President's proposal in several major respects. First, the tax is not permanent but temporary: it remains effective until it generates $227.3 billion or until January 1990,

2. Address to the Nation, 15 WEEKLY COMP. OF PRES. DOC. 610 (Apr. 5, 1979). The President's decontrol program involved immediate decontrol of certain (newly discovered) oil, a gradual release of lower tier (old oil) into the upper tier (new oil), and a gradual increase in the upper tier ceiling price to the world price.

3. DEMOCRATIC STUDY GROUP, WINDFALL PROFIT TAX CONFERENCE REPORT FACT SHEET, H.R. Doc. No. 29, 96th Cong., 2d Sess. 1 (1979) [hereinafter cited as FACT SHEET].

4. Message to Congress, 15 WEEKLY COMP. OF PRES. DOC. 722 (Apr. 26, 1979).

5. *Id.* at 723-25. The market incentive base price for the fourth quarter of 1979 was $16.00 per barrel, adjusted for inflation.

6. *Id.* at 723.

7. *Id.* at 725.

8. FACT SHEET, *supra* note 3, at 4.

9. 15 WEEKLY COMP. OF PRES. DOC. 726 (Apr. 26, 1979).

10. Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, § 101, 94 Stat. 229 (codified in scattered sections of the Internal Revenue Code of 1954, 26 U.S.C.).

whichever is later.[11] Second, the tax rates, although flat percentages, vary depending on the type of oil produced and on the type of producer, independent or major.[12] Third, the Act grants tax relief to high-cost properties through a "net income" limitation on the "windfall profit."[13] Fourth, the new Act does not affect percentage depletion. Thus, independents (and others entitled to the deduction) may take depletion on the amount representing the windfall.[14] Finally, the Act establishes no trust fund for the billions of dollars generated by the tax. Instead, revenues will go into the general Treasury fund, to be allocated as follows: Congress proposes that twenty-five percent of the net revenues go to aid the poor in coping with rising energy costs, fifteen percent to support mass transit and conservation measures, and the remaining sixty percent to offset business and individual tax cuts. The Act allocates no funds to the production of synthetic fuels.[15]

The new tax is complicated and ambiguous; it has tremendous implications for oil companies, royalty owners, purchasers of oil, and consumers. This article discusses the nature of the new tax, the method of its calculation, its exemptions, its potential administrative and enforcement problems, the way that Congress will spend the billions of dollars generated by the tax, and its effect on production incentives and the economy. In particular, the article focuses on two major policy issues: 1) Will the new tax effectively promote the energy objectives of this country, *i.e.*, reducing our dependence on foreign oil and developing alternative energy sources,[16] and 2) Is the proposed windfall profit tax, as set forth in the Act, the best way to accomplish this purpose?

II. TAX COMPUTATION

The title of the Act is, in part, a misnomer. The windfall profit tax imposed under new section 4988(a) of the Internal Revenue

11. I.R.C. § 4990. Unless otherwise indicated, all references to sections are to the Internal Revenue Code of 1954, as amended.

12. *Id.* § 4987; *see* note 86 and accompanying text *infra*.

13. I.R.C. § 4988; *see* note 190 and accompanying text *infra*.

14. CONFERENCE REPORT, H.R. REP. No. 817, 96th Cong., 2d Sess. 110 (1980) [hereinafter cited as CONFERENCE REP.]. Congress adopted the Conference Committee Report without modification upon passing the windfall profit tax.

15. *See* note 251 and accompanying text *infra*.

16. THE WHITE HOUSE, THE NATIONAL ENERGY PLAN IX (1977). The President concluded that the country's energy objectives were to reduce its dependence on foreign oil and its vulnerability to supply interruptions immediately and, in the long run, to have renewable and inexhaustible sources of energy for sustained growth.

Code is not a tax on the profits of the oil companies, but an excise tax or severance tax on the *sale* of crude oil produced domestically. According to this section, the term "windfall profit" equals the excess of the "removal price"[17] of the barrel of crude oil over the sum of the "adjusted base price"[18] of that barrel and the amount of the severance tax adjustment.[19] Basically, the calculation under that formula amounts to the difference between the current sales price of crude oil and the price of the oil as controlled in 1979 under the energy pricing regulations, with adjustments for inflation and the severance tax. Although sales are the key in the calculations under section 4988(a), profits are the key in section 4988(b), which limits the windfall by taking costs into account and by imposing a ceiling on the taxable "windfall profit" equal to 90% of the net income from a barrel of oil.[20] The net income is determined by dividing the yearly taxable income from the property by the number of barrels of taxable crude produced from the property in the taxable year.[21] This net income limitation was not part of Carter's original proposal; it was added by both the House[22] and the Senate[23] Reports to ensure that the costs of exploration, drilling, and production would be taken into account. Thus, the tax does not penalize high cost properties.

Neither the calculations under section 4988(a) nor those under 4988(b) are easy to compute. Under section 4988(a), one must determine the category or type of oil being produced, the taxable event that triggers the tax, the removal price or selling price of the oil, the base price, the base price adjustments, and the severance tax adjustment. Under section 4988(b), one must determine the property from which the crude oil is produced, the taxable income from the property, and the cost depletion deduction from the taxable income. Each element of the windfall tax will be discussed in turn.

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17. I.R.C. § 4988(a).

18. *Id.*

19. *Id.* § 4988(b).

20. *Id.* § 4988(b)(1).

21. *Id.* § 4988(b)(2).

22. H.R. REP. No. 304, 96th Cong., 1st Sess. 37 (1979) [hereinafter cited as H. REP.]. The House proposed a 100% net income limit.

23. S. REP. No. 394, 96th Cong., 1st Sess. 58 (1979) [hereinafter cited as S. REP.]. The Senate endorsed the 90% limit.

A. *Categories of Oil*

The types of oil subject to the windfall tax fall under the general definition of "crude oil." Section 4996(b)(1) defines "crude oil" as the energy regulations define it: "a mixture of hydrocarbons that existed in liquid phase in underground reservoirs and remains liquid at atmospheric pressure after passing through surface separating facilities."[24] This definition also includes "condensate recovered in associated or nonassociated production by mechanical separators whether located on the lease, at central field facilities, or at the inlet side of a gas processing plant."[25] Crude oil also includes natural gas liquid[26] but does not include synthetic petroleum, shale oil, or products from coal or tar sands.

To understand the changes implemented by the Act, one must examine the prior law's categorization of oil. The price controls of May 1979 divided crude oil into "old oil" and "new oil." "Old oil," also referred to as "first tier oil" and "lower tier oil," consisted of oil in production before 1973 up to the lesser of the production levels in 1972 and 1975, adjusted for estimated decline.[27] "New oil," also referred to as "second tier oil" and "upper tier oil," consisted of oil in production after 1972, as well as oil in production before 1973 that exceeded the 1972 or the 1975 production level, adjusted for estimated decline.[28] The production level in 1972 or 1975 constituted the base production control level (BPCL), an essential element for determining the category into which the oil fell.

Both the House Report[29] and Senate amendment[30] proposed a windfall tax that placed "old oil" in one category and "new oil" in another. Each category was to have a different base price and tax rate. The final bill, however, combines these types of oil into one tier, thus simplifying the structure of the tax and eliminating the BPCL calculation.

The Act divides "crude oil" into three tiers. Section 4991(c) defines Tier 1 oil as "any taxable crude oil other than—(1) tier 2 oil, and (2) tier 3 oil." Although this section does not describe the specific kinds of oil that make up Tier 1, one would assume that

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24. Mandatory Petroleum Price Regulations, 10 C.F.R. § 212.31 (1980).
25. *Id.*
26. *Id.*
27. *Id.* § 212.73 (1974).
28. *Id.* § 212.74. Under these pricing regulations stripper oil, incremental oil, and oil produced on the Naval Petroleum Reserve were exempt. *Id.* § 212.54, .55 (1980).
29. *See* H. REP., *supra* note 22, at 16, 20.
30. *See* S. REP., *supra* note 23, at 30, 35.

the category includes "old oil" and "new oil," marginal oil,[31] high water-cut oil,[32] oil from Cook Inlet (near Anchorage, Alaska), and oil from the Sadlerochit Reservation on Alaska's North Slope.[33] Except for Sadlerochit oil, to which a special base price adjustment applies, the definitions of the specific types of oil making up Tier 1 are not that significant under the windfall tax. These types of oil share the same base price and the least preferential tax rate.[34] What is important under the new tax is the definition of Tier 2

31. A Department of Energy (DOE) rule published on April 12, 1979, classifies oil produced from "marginal properties" as generally eligible for upper tier prices. Pursuant to this rule, specific properties qualify as "marginal," depending upon the average production level at different average well depths. A property would qualify as marginal if, for calendar year 1978, the average completion depth of all the property's producing wells and the average daily per well production from the property met the following limits:

Average depth (in feet)	Average daily production (in bbls.)
2,000 but less than 4,000	20 or less
4,000 but less than 6,000	25 or less
6,000 but less than 8,000	30 or less
8,000 or more	35 or less

To qualify as a marginal property, each well on the property must have been maintained at the maximum feasible rate of production consistent with recognized conservation practices throughout the calendar year 1978. In addition, production from each well on the property must not have been curtailed significantly by reason of mechanical failure or other disruption in production. For pricing purposes:

> With respect to marginal properties the base production control level equals (1) with respect to months commencing after May 31, 1979, 20 percent of the total number of barrels of old crude oil produced and sold from the property concerned during calendar year 1978, divided by 365, multiplied by the number of days during the month in 1978 which corresponds to the month concerned; (2) for the months commencing after December 31, 1979, zero.

10 C.F.R. § 212.72(2)(d) (1980).

32. High water-cut oil is production from a property on which the average water-oil ratio for all wells was at least nine to one for any consecutive twelve-month period beginning after 1977. In addition, to qualify as a high water-cut property, each well on the property must have been maintained at the maximum feasible rate of production consistent with recognized conservation practices throughout the twelve-month measuring period. Furthermore, production from each well on the property must not have been curtailed significantly by reason of mechanical failure or other disruption in production. Once the property meets this nine-to-one ratio for a twelve-month period, it is classified as a high water-cut property for all periods thereafter. *See* S. REP., *supra* note 23, at 35. Although not specifically defined by either the Conference Committee Report or the Act, high water-cut oil is referred to in the former. *See* CONFERENCE REP., *supra* note 14, at 93. The Report emphasizes the important contribution of high water-cut crude oil to our domestic supplies and makes it clear that the DOE may provide special price treatment for this oil if it deems such action appropriate. *Id.*

33. Sadlerochit oil is taxed like other Tier 1 oil, with two variations. First, its adjusted base price may be increased to reflect any decrease in the Trans-Alaska Pipeline System (TAPS) tariff below $6.26 a barrel. Second, the tax is calculated on the basis of monthly average removal prices for each producer. *See* CONFERENCE REP., *supra* note 14, at 103.

34. *See id.*

and Tier 3 oil. Since these oils receive special tax treatment, producers will seek to include their oil in one of these categories.

Under the Act, Tier 2 consists of stripper oil and oil produced on a National Petroleum Reserve in which the United States has an economic interest.[35] "Stripper oil" carries the same definition under the tax rules as under the June 1979 energy regulations,[36] *i.e.*, oil produced on properties with an average daily production (BPCL) per well of ten barrels or less for any consecutive twelve-month period after 1972.[37] Congress was obviously concerned that some producers might transfer portions of their properties to create new properties qualifying for stripper oil treatment. To prevent this tactic, section 4996(e) stipulates that oil produced from a portion of a property transferred after 1978 cannot constitute stripper oil if it would not have qualified as stripper oil before the transfer.

The House and Senate proposals defining Tier 2 differ from the definition under the Act. Under the House proposal, Tier 2 consisted of all "new oil" plus excess and marginal oil and front-end tertiary oil.[38] Under the Senate proposal, Tier 2 was the same but also included Cook Inlet oil, Alaskan North Slope oil from the Sadlerochit field, deep marginal oil, and high water-cut oil.[39]

The Act defines Tier 3 to include newly discovered oil, incremental tertiary oil, and heavy oil.[40] The first type, newly discovered oil, carries the same definition under the tax rules[41] as under the energy regulations.[42] Thus, newly discovered oil is crude oil sold after May 31, 1979, and produced from: 1) an outer continental shelf area leased on or before Janaury 1, 1979, from which there was no production of oil in calendar year 1978; or 2) an onshore property from which no crude oil was produced in calendar year 1978.[43] Oil produced from a previously developed property from which there was no production in calendar year 1978 is treated as newly discovered oil. "Thus, it includes production from a property on which oil was produced in 1978 if that production was incident

35. I.R.C. § 4991(d). It is unclear exactly what "National Petroleum Reserve" means—whether it is synonymous with Naval Petroleum Reserve oil or is broader in definition. Naval Petroleum Reserve oil is defined in Mandatory Petroleum Price Regulations, 10 C.F.R. § 212.55 (1980).

36. Mandatory Petroleum Price Regulations, 10 C.F.R. § 212.54 (1980).

37. *Id.*

38. H. REP., *supra* note 22, at 20.

39. S. REP., *supra* note 23, at 34.

40. I.R.C. § 4991(e)(1).

41. *Id.* § 4991(e)(2).

42. Mandatory Petroleum Price Regulations, 10 C.F.R. § 212.79 (1980).

43. I.R.C. § 4991(e)(1).

to the drilling of exploratory or test wells and was not part of continuous or commercial production from the property during 1978."[44] As in the case of stripper oil,[45] Congress sought to prevent producers from circumventing the Act, by disallowing newly discovered oil status for property transferred after 1978 if the oil "would not be so classified if the property had not been transferred."[46]

The second type of Tier 3 oil, incremental tertiary oil, is defined differently under the tax rules than under the energy regulations. Section 4993 defines incremental tertiary oil as oil produced from a property on which a producer uses a qualified tertiary recovery method[47] in excess of the property's base production control level (BPCL). The BPCL is the average daily amount, reduced at 1% per month for each month since 1978 before initiation of the project, and at 2.5% per month for each month thereafter, or the actual decline if it is greater.[48] The incremental tertiary provision applies both to new projects and to significant expansions of existing projects.[49] Under the Act, the incremental tertiary project may be certified by a government regulatory authority[50] or by the producer itself. Under this self-certification process, a petroleum engineer must verify that the project involves one or more tertiary recovery methods, that these methods are applied in accordance with sound engineering principles,[51] and that the project has a be-

44. CONFERENCE REP., *supra* note 14, at 98.

45. *See* text accompanying notes 36-37 *supra*.

46. I.R.C. § 4996(e).

47. Qualified tertiary recovery methods are one or more of several specified chemical, fluid, or gaseous recovery techniques, including: 1) miscible fluid displacement, 2) steam drive injection, 3) microemulsion or micellar emulsion flooding, 4) in situ combustion, 5) polymer augmented flooding, 6) cyclic steam injection, 7) alkaline or caustic flooding, 8) carbon dioxide augmented water flooding, and 9) immiscible carbon dioxide displacement. *See* CONFERENCE REP., *supra* note 14, at 98.

48. *See id.* at 102.

49. I.R.C. § 4993(c).

50. In the case of projects located on land under federal jurisdiction, projects could be certified by either the U.S. Geological Survey or pursuant to an approved DOE application. Other projects could be certified by an appropriate state agency designated by the governor of the state in which the project is located. If no state regulatory body is designated to certify the projects, the U.S. Geological Survey could certify the project. *See* S. REP., *supra* note 23, at 46.

51. These principles require a thorough examination of the particular formation in question, its geological characteristics, permeability, reservoir pressure, and current and projected productivity ratios. These principles also may require analysis of viscosity, pressure build-up, and sweep efficiency. They clearly necessitate a comparative examination of various stimulative methods based on formation type, and statistical data relating to actual and projected well performances, process costs, and anticipated investment return under reason-

ginning date after May 1979.[52] The engineer must state that the methods can be expected to result "in more than an insignificant increase in the amount of crude oil which will ultimately be recovered."[53] In general, the excise tax definition of tertiary oil is broader and more generous than the definition under the pricing regulations. The energy pricing rules define "incremental production" as oil produced beyond what normally would have been produced without applying the enhanced recovery technique.[54]

The third type of Tier 3 oil, heavy oil, is defined by section 4991(e)(3), which differs from the definition under the pricing regulations.[55] For tax purposes, heavy oil includes the oil produced from a property, where, during the last month of production before July 1979, all crude had a weighted average gravity of 16° or less, corrected to 60° F.[56] Heavy oil also includes properties producing crude of that average gravity during the taxable period.[57] Thus, the classification of crude oil from a particular property as "heavy oil" may vary from period to period. For example, if a property did not produce before July 1979 or did not produce crude with a weighted average gravity of 16° or less during the last production month before July 1979, it can still qualify as heavy oil during any calendar quarter in which its production of crude averages 16° or less.

As in the case of other oils, Congress sought to avoid the transfer of property merely to receive a favored classification. To this end, the Act includes a provision that prevents a producer from transferring property simply to meet the definition of heavy oil.[58]

Unlike the tax rules, the pricing regulations provide that property not qualifying for heavy oil status before July 1979 cannot later qualify, notwithstanding future developments.[59] Additionally, for pricing purposes, the definition of heavy oil includes all crude oil produced from a property, but *only if* during the last month before July 1979 in which crude oil was produced and sold from the property, the crude oil had a weighted average gravity of 20° or

able assumptions of future oil prices. *See id.* at 48.

52. I.R.C. § 4993(c)(2)(A).

53. *Id.* § 4993(c)(2).

54. Mandatory Petroleum Price Regulations, 10 C.F.R. § 212.78 (1980).

55. *Id.* § 212.75.

56. I.R.C. § 4991(e)(3).

57. *Id.*

58. *Id.* § 4996(e).

59. Mandatory Petroleum Price Regulations, 10 C.F.R. § 212.75 (1980).

less, corrected to 60° F.[60]

Tier 3 classification under the Act differs somewhat from the classification under the House and Senate proposals. Under the House Report,[61] Tier 3 oil consisted of certain types of newly discovered oil,[62] stripper oil, Alaskan oil, and incremental tertiary oil. The Senate Report[63] placed stripper oil and oil from the Naval Petroleum Reserve in Tier 3.

Experience with the energy regulations has indicated that a common area of dispute has been the classification of oils. Consider, for example, the stripper oil exemption. Arguments have arisen over whether one should include production from injection wells when computing the average daily production[64] and whether the stripper exemption should include a gas well's condensate (liquid hydrocarbons of gas wells).[65] Department of Energy (DOE) rulings interpreting the regulations have been ambiguous and have confused producers, who have had trouble determining the proper category for their oil. Similar problems may develop with the windfall profit tax if the Internal Revenue Service (IRS) does not lay down specific guidelines. Controversies about incremental tertiary oil and front-end tertiary oil most assuredly will arise,[66] since the tax definitions of these types of oil differ significantly from the DOE definitions. Moreover, the areas of expertise of these federal agencies seem to compound the problem. The IRS does not have the DOE's expertise in defining crude oil. Thus, the task of establishing definite guidelines may be difficult. Apparently foreseeing the potential problems in defining incremental tertiary oil, Congress specifically provided for advance IRS determination in establishing the status of a tertiary project.[67]

Much of the problem with classifying oil under the DOE pricing regulations revolves around determining "base production control level" (BPCL) and "property."[68] "Property" is a key concept in defining stripper oil, incremental tertiary oil, newly discovered oil, and heavy oil. BPCL, although no longer important in distin-

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60. *Id.*

61. H. REP., *supra* note 22, at 22.

62. *Id.* at 28.

63. S. REP., *supra* note 23, at 37.

64. Energy Reserves Group, Inc. v. FEA, 589 F.2d 1082 (Temp. Emer. Ct. App. 1978).

65. Southern Union Prod. Co. v. FEA, 569 F.2d 1147 (Temp. Emer. Ct. App. 1978).

66. *See* note 131 and accompanying text *infra*.

67. I.R.C. § 4993(d)(7).

68. *See* Beck, *Crude Oil Issues*, in 30TH ANNUAL INSTITUTE ON OIL AND GAS LAW 1 (1979).

guishing upper tier from lower tier oil, remains important in defining stripper oil and incremental tertiary oil. Since BPCL is never defined in the Act, it presumably has the same definition as under the pricing regulations.[69]

Considerable confusion has resulted from the BPCL concept, largely because it is based on "property." Under the windfall profit tax, "property" is defined in two ways, one for determining the net income limit under section 4988(b)[70] and another for defining the particular type of oil. For defining oil, property is defined in the same manner as under the energy rules:[71] 1) as a right to produce domestic crude oil that arises from a lease or fee interest; or 2) at the election of the producer, as separate and distinct producing reservoirs that are subject to the same right to produce and are recognized as separate and distinct reservoirs by the appropriate government regulatory authority. The first part of this definition of property is used in section 613 of the Code and section 4988(b) of the Act. The DOE adopted the second part of the definition, a new concept to the Code, to accommodate so-called unitization agreements. These agreements arise when producers of several properties enter joint or "unitized" agreements to facilitate the economic production of oil from their properties.[72] By pooling their resources and properties, producers could better undertake various pressure maintenance and secondary or tertiary recovery programs. And, because of DOE rules defining property, producers could keep their classification of production as if they had not entered into the agreement. Both the House Report[73] and the Senate Report[74] discuss unitization, stating that the Secretary of the Treasury should anticipate adopting or modifying the unitization rules of the DOE to accomplish the purposes of the windfall profit tax. Section 4997(b), although broadly phrased, gives the Secretary just such authority. Thus, many of the problems associated with categorizing oil may be alleviated through clear, detailed regulations.

69. *See generally* Mandatory Petroleum Price Regulations, 10 C.F.R. § 212.72 (1980).

70. *See* note 190 and accompanying text *infra*.

71. *Id.*

72. Effective September 1, 1976, the FEA amended 10 C.F.R. § 212.72 to permit producers to "treat as a separate property each separate and distinct producing reservoir subject to the same right to produce crude oil." *See* Mandatory Petroleum Price Regulations, 10 C.F.R. § 212.72 (1980).

73. H. REP., *supra* note 22, at 32.

74. S. REP., *supra* note 23, at 53.

B. *The Tax Rate*

The tax rate on the windfall profits will vary, depending on the category into which the oil falls and the type of producer involved. For major oil producers, the tax rate on Tier 1 oil is 70%, and on Tier 2 oil, 60%.[75] For independent producers, the rates are 50% and 30% for Tiers 1 and 2 respectively.[76] The applicable tax rate for Tier 3 oil is 30% for both major and independent producers.[77]

The House and Senate proposals differed concerning what exemptions and preferences, if any, independent producers and others would receive. The House version of the Act gave no special preference to the independent producer. The Senate amendment, however, exempted the first 1,000 barrels per day of otherwise taxable oil produced by independent producers and certain royalty owners.[78] The Conference Committee Report, adopted by Congress in passing the Act, took a compromise position: rather than exempting the 1,000 barrels per day, it reduced the tax rate on these barrels.[79] This reduced rate, moreover, applies only to oil classified as Tier 1 or Tier 2.[80] Finally, the reduced rate applies only to production attributable to independent producers, not to royalty owners.[81] Any oil produced beyond the 1,000 barrel limit is taxed at 70% in Tier 1 and 60% in Tier 2. In these circumstances, the independent producer classifies Tier 1 and Tier 2 oil in proportion to total production.[82] Within either tier, classification is based on the highest removal price.[83]

Section 4992 defines an independent producer as a producer who refines no more than 1,000 barrels of crude oil on any day in the taxable quarter or sells no more than $1,250,000 quarterly of oil or natural gas products through retail outlets or under trademarks or tradenames.[84] If a person belongs to a related group, the 1,000 barrel amount must be allocated among the members of the group "in proportion to their respective qualified production for

75. I.R.C. § 4987.
76. *Id.*
77. *Id.*
78. S. REP., *supra* note 23, at 39.
79. CONFERENCE REP., *supra* note 14, at 109.
80. I.R.C. § 4992(d)(1)(C).
81. *See id.* § 4992.
82. *Id.* § 4992(c)(2).
83. *See* CONFERENCE REP., *supra* note 14, at 109.
84. I.R.C. § 4992(b)(1) (citing I.R.C. § 613A(d)).

such quarter."[85] For this purpose, a related group consists of members of the same family,[86] a controlled group of corporations,[87] a group of entities under common control,[88] or "if 50 percent or more of the beneficial interest in 1 or more corporations, trusts, or estates is owned by the same family, all such entities and such family."[89] To qualify for the reduced rate the independent producer must have a "working interest" in the property, defined as an "operating mineral interest" under section 614(d).[90] A working interest, in general, is an interest in crude oil that bears the cost of production or would be required to pay such costs if the well were in the production stage.[91] Generally, such interests are those in which the cost of production must be taken into account in computing the net income limit on percentage depletion. The term does not include royalty interests or similar interests such as production payments or net profit interests that would essentially constitute nonoperating interests.[92] A "qualified overriding royalty interest,"[93] however, may constitute a working interest. To qualify, such an interest must be converted into a working interest under a binding contract or agreement in effect on February 20, 1980, or be converted between January 1, 1980, and February 20, 1980.[94] After such conversion, the production from the working interest qualifies for the reduced rates for the independent producer.

Certain transferred properties are ineligible for the reduced rates.[95] In general, properties transferred from one person to another will not qualify for the reduced rate if the transfer would disqualify the transferee from claiming percentage depletion on the property.[96] The transfer rule under the Act, however, differs

85. *Id.* § 4992(e)(1).

86. For this purpose a family is an individual and the spouse and minor children of that individual. *Id.* § 4992(e)(3)(C).

87. *Id.* § 4992(e)(3)(A) (citing *id.* § 613A(c)(8)(D)(i)).

88. *Id.* § 4992(e)(3)(B) defines a "group of entities under common control" as any group of corporations, trusts, or estates that are under common control as determined under regulations prescribed by the Secretary.

89. *Id.* § 4992(e)(2)(D). An interest owned by or for a corporation, partnership, trust, or estate is considered as owned directly by the entity and proportionately by its shareholders, partners, or beneficiaries. *Id.* § 4992(e)(3)(D).

90. *Id.* § 4992(d)(1)(D).

91. *Id.* § 614(d).

92. *Id.* § 614(e)(2).

93. *See* note 109 and accompanying text *infra*.

94. I.R.C. § 4992(d)(2)(B).

95. *Id.* § 4992(d)(3)(A).

96. *Id.* § 4992(d)(3)(B)(i).

from the same rule under depletion in two major ways:[97] 1) Transfers between an individual and a controlled corporation do not disqualify a property for the reduced rate because these persons must share one 1,000 barrel amount; and 2) a more flexible rule applies to transfers between small, independent producers. An exemption from the general transfer rule applies to small producers if the transferee can show that at no time after December 31, 1979, has the property been held by either a major oil company or an independent producer who has exceeded his qualified production for any quarter ending after September 30, 1979, and before the person transferred the interest.[98] In the case of transfers from a trust, partnership, or estate, the oil is deemed owned proportionately by the beneficiaries or partners for purposes of determining whether the transferor is a person whose ownership would make the property ineligible for the reduced rate.[99] The Secretary of the Treasury is to set up a mechanism for producers to demonstrate that their transferred properties are eligible for the reduced rate.[100]

The tax rates imposed under the windfall profit tax are to be phased out during a thirty-three month period beginning in either January 1988 or the month after the Secretary of Treasury estimates that $227.3 billion has been generated by the tax, whichever is later.[101] The phaseout must begin, regardless of the amount generated, by January 1991. For each month during this phaseout period, the producer's tax rate is reduced by 3 percent. Thus, for example, in the case of an independent producer of Tier 2 oil, the tax would terminate in ten months, whereas in the case of a major oil producer of Tier 3 oil, phasing out would take twenty months, or twice as long.

C. *Taxpayer*

The windfall profits tax is imposed on the "producer,"[102] generally defined as the holder of the economic interest in the oil.[103] "Economic interest" is determined under the same rules applicable for federal income tax purposes (*i.e.*, the depletion allowance rules): An interest is economic if the taxpayer "has acquired by

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97. CONFERENCE REP., *supra* note 14, at 109.
98. I.R.C. § 4992(d)(3)(B)(i)-(ii).
99. *Id.* § 4992(d)(3)(B)(iii)(I)-(II).
100. *Id.* § 4992(d)(3)(B)(i).
101. *Id.* § 4990(c).
102. *Id.* § 4986(b).
103. *Id.* § 4996(a)(1)(C).

[capital] investment any interest in mineral in place . . . and secures, by any form of legal relationship, income derived from the extraction of the mineral . . ., to which the [taxpayer] must look for a return of his capital."[104] If the owner of mineral property transfers an interest in that property and receives consideration payable only if and when oil is extracted, the owner is considered to have an economic interest or lease interest in the property. If, on the other hand, the owner is to receive consideration for the transfer of the property irrespective of production, this constitutes a sale of the mineral interest and is not considered an economic interest.[105] Thus, economic interest is a nonoperating interest in contrast to a working interest, discussed above in the definition of independent producers.[106] In general, economic interests include net profit interests, royalties, overriding royalties, and production payments.

A *net profits interest* is a share of gross production measured by net profits from operating the property.[107] These profits are determined by subtracting from the property's gross income certain specified taxes and costs of development and operation.[108] If there is no profit from the operation of the property, however, the owner of the interest receives nothing. If there is a net loss, the owner is not liable for any share of the loss.

A *royalty* is a right to oil in place that entitles its owner to a specified share, in kind or value, of the total production from the property, free of development and operation expenses.[109] Typically, a royalty entitles the owner of the premises to compensation from the lessee for the privilege of drilling and producing oil and gas. An *overriding royalty* resembles an ordinary royalty but is created from the operating or working interest.[110] In such a case the interest is carved out of the lessee's share of the oil. Royalty payments, whether underlying or overriding, extend to the entire future production from the premises.

Royalty payments should be contrasted to *production payments*, which terminate when a specified amount is produced. A production payment is a right to a specified share of production

104. Treas. Reg. § 1.611-1(b)(1979). *See generally* Rev. Rul. 53-78, 1953-1 C.B. 18.

105. *See* authorities cited note 104 *supra*.

106. *See* notes 90-94 and accompanying text *supra*.

107. Rev. Rul. 75-182, 1975-1 C.B. 176.

108. I.R.C. § 4998 (citing *id.* § 613(A)).

109. *See* BURKE & BONWAY, INCOME TAXATION OF NATURAL RESOURCES § 2.03 (1979 ed.).

110. *Id.* § 2.05.

from the mineral in place (if and when produced), or to the proceeds from such production when the payment has an economic life (at the time of its creation) of shorter duration than the economic life of the related mineral property.[111] For example, when an agreement creates a royalty equal to 5% for five years and thereafter equal to 4% for the balance of the life of the mineral property, an amount equal to 1% for five years constitutes the production payment.[112] The House bill[113] made an exception to the general rule that an owner bears the tax burden for production payments that involve disbursements to someone until the cumulative payment equalled a fixed number of dollars (as opposed to a fixed number of barrels). This bill would have shifted the tax burden to the holder of the residual interest. The Act itself, however, makes no special provision for production payments. Such a provision is not thought necessary, because "production payment contracts usually provide for an automatic adjustment to reflect the imposition of additional severance taxes such as the windfall profit tax."[114] Nor do all production payments constitute an economic interest in the property. A production payment carved out of the mineral property is treated as a mortgage loan on the property rather than as an economic interest.[115]

In general, the person receiving the income from the oil production will bear the burden of the windfall tax. Each investor and royalty owner with an economic interest in the oil is liable for the tax on his share of the gross revenue. In a partnership, the interest is allocated among the partners in proportion to their interests in the partnership.[116]

D. *Exemptions*

Section 4991(b)(1) exempts economic interests in crude oil held by a state or a political subdivision thereof (or agency or instrumentality of the state) from the windfall tax.[117] Unlike the House proposal, which provided an exemption only if the net income from such institutions was used directly or indirectly to

111. Treas. Reg. § 1.636-3(a)(1) (1979).
112. *Id.* § 1.636-3(a)(2).
113. H. REP., *supra* note 22, at 40.
114. *Id.* at 62.
115. I.R.C. § 636(a).
116. *Id.* 4996(a)(1)(B).
117. A "qualified governmental interest" is defined by *id.* § 4994(a)(1).

finance public education,[118] the Act permits an exemption if all of the net income derived from such an interest is dedicated either to education or to a public purpose.[119] Although "public purpose" is not defined, it probably includes all the purposes for which taxes are customarily levied, such as expenditures to promote the public health, safety, morals, general welfare, security, prosperity, and contentment of residents within the state or political division.[120] Net income for this purpose equals gross income from the property, less production costs and severance taxes of general application.[121] A severance tax for this purpose represents any tax imposed at a uniform rate on the owners of the right in oil production, both public and private.[122]

Under section 4991(b)(1), economic interests in crude oil owned by charitable medical facilities[123] and educational institutions[124] are exempt from the tax if the properties producing oil were owned or received as a bequest by that facility or institution as of January 21, 1980.[125] Oil produced from interests held by a church on January 21, 1980, is exempt if before January 22, 1980, the net proceeds from the production of oil were dedicated to the support of a medical facility or educational institution.[126]

Also exempt from the windfall tax are economic interests in crude oil owned by recognized Indian tribes, individual members of such tribes, or tribal organizations, if the oil is produced from tribal lands[127] or lands held subject to federally imposed restrictions

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118. H. REP., *supra* note 22, at 39.

119. I.R.C. § 4994(a)(1).

120. *See, e.g.*, Green v. Frazier, 44 N.D. 395, 176 N.W. 11 (1920).

121. I.R.C. § 4994(a)(2).

122. *See* CONFERENCE REP., *supra* note 14, at 107 (following S. REP., *supra* note 23, at 60).

123. A charitable medical facility is defined as an organization the principal purpose or function of which is the providing of medical or hospital care or medical education, or if in conjunction with a hospital, medical research. CONFERENCE REP., *supra* note 14, at 109; *see* I.R.C. § 4994(b)(1).

124. An educational institution is an organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where its educational activities are regularly carried on. Also classified as educational institutions are organizations that normally receive a substantial part of their support from the United States or any state or political subdivision thereof or from direct or indirect contributions from the general public, and that are organized and operated exclusively to receive, hold, invest, and administer property and to make expenditures to or for the benefit of a public college or university. I.R.C. § 4994(b)(1)(A) (referring to *id.* § 170(b)(1)(A)).

125. *Id.* § 4994(b)(1)(B).

126. *Id.* § 4994(b)(2).

127. Tribal Trust Lands are land and mineral interests, title to which is held by the United States in trust for Indian tribes or their members.

on alienation.[128] In general, this exemption conforms to various court decisions and IRS rulings, which hold that income from Tribal Trust Land is exempt from income tax.[129] Unlike the House and Senate proposals, which made no provision for non-Indian oil production, section 4994(d)(2) provides an additional exemption for oil produced by Alaska Native Corporations organized under the Alaska Native Claims Settlement Act.[130]

Besides exempting economic interests owned by states, charitable organizations, and Indian tribes, the Act exempts certain Alaskan oil and, under certain circumstances, front-end tertiary oil.

1. FRONT-END TERTIARY OIL

In addition to reduced rates on Tier 1 and Tier 2 oil, the independent producer may also obtain a tax preference for "front-end tertiary" oil. Under a DOE rule, producers investing in enhanced oil recovery projects before October 1981 may deregulate the price of specified volumes of price-controlled oil, called front-end tertiary oil, to finance their investment.[131] Revenue from the sale of this released production may not exceed 75% of certain specified expenses actually incurred for enhanced oil recovery.[132] No more than $20,000 of expenses can be recouped for a particular project. No limit is placed, however, on the number of projects for which a producer can recoup expenses through the release of oil at the market price. The rule permits producers to deregulate oil produced from properties other than the one on which the project is located.

Section 4994(c) exempts from the windfall tax any oil that the DOE deregulates as front-end tertiary, provided the project is "controlled" by producers who are independent for the fourth quarter of 1979. If, however, the oil could have been released from DOE price controls under any other part of the DOE pricing regulations, it cannot qualify for this exemption. In addition, oil deregulated to finance prepaid expenses, *i.e.*, expenses attributable to

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128. I.R.C. §§ 4991(b)(2), 4994(d)(1)(B).

129. CONFERENCE REP., *supra* note 14, at 108 (following S. REP. *supra* note 23, at 61).

130. The exemption applies if the oil is produced before 1992 and the proceeds from the sale of the oil are paid into the U.S. Treasury to the credit of tribal or native trust funds under provisions of law in effect before January 22, 1980. I.R.C. § 4994(d)(2).

131. Mandatory Petroleum Price Regulations, 10 C.F.R. § 212 (1980); CONFERENCE REP., *supra* note 14, at 93.

132. *See* authorities cited note 131 *supra*.

periods after September 30, 1981, cannot qualify. Thus, this special treatment of tertiary oil will end on September 30, 1981.

A tertiary project is considered controlled by an independent producer or major oil company (one involved in exploration, production, refining, marketing) if on January 1, 1980, 50% or more of the operating mineral interest in the property (or portion thereof) on which the project was being undertaken was owned, directly or indirectly, by or for the major or independent company.[133] Ownership of the front-end tertiary oil itself is irrelevant for this purpose. If the independent producer controls the tertiary project, the front-end tertiary oil is exempt, even if the oil is produced by a major oil company. If the project is controlled by a major oil company or the oil is produced by a major or independent producer, all front-end tertiary oil related to the project is subject to the tax. Under these circumstances, the independent producer or major oil company is entitled to a refund of, or an adjustment for, windfall profit taxes paid on the oil. The refund or adjustment would equal the qualifying recoupable tertiary recovery expenditures for the project, less the amount actually recouped under the front-end financing program.[134]

The front-end tertiary exemption or refund does not apply to expenditures attributable to periods after September 30, 1981, or so-called prepaid expenses. Some pre-October 1, 1981, expenditures may be allowed, however, even though they represent items completed, placed in service, or used after that date, if income tax deductions are properly attributable to the items for periods before October 1, 1981.[135] For instance, an exemption would be allowable for expenditures made in the ordinary course of business for a service that reasonably could be expected to be performed prior to October 1, 1981. Such a "reasonable" expectation would be found if the service would have been completed before October 1, 1981, but for the occurrence of an event beyond the producer's control.[136] An act of God (which expressly includes a strike), a severe mechanical breakdown, or an injunction are events contemplated as beyond the producer's control.[137] Determinations of allowable pre-October 1981 expenses will depend upon the circumstances

133. I.R.C. § 4994(c)(4)(C).
134. *Id.* § 4994(c)(2).
135. *Id.*
136. CONFERENCE REP., *supra* note 14, at 94.
137. *Id.*

and will have to be made on a case-by-case basis.[138]

2. ALASKAN OIL

Section 4994(e) exempts from the windfall tax all Alaskan oil produced from wells located north of the Arctic Circle (including production from the Lisburne and Kuparuk formations in the Prudhoe Bay oil fields). In addition, the Act exempts Alaskan oil produced from any well that yields oil from a reservoir that has been commercially exploited by a well located north of the Arctic Circle. Also exempted is Alaskan oil south of the Arctic Circle but north of the divide of the Alaska-Aleutian mountain range, if it is produced from a well at least seventy-five miles from the nearest point on the Trans-Alaska Pipeline System. The purpose of exempting the Alaskan oil, as stated by the Committee Report, is to encourage exploration and development of reservoirs in areas of extreme climatic conditions.[139] Nonexempt Alaskan oil, such as oil from the Sadlerochit Reservoir or from Cook Inlet, is classified for tax purposes as Tier 1 oil.

E. *Taxable Event*

Under the Act, crude oil becomes taxable when it is "removed" from the premises during each "taxable period," defined as a calendar quarter.[140] In general, removal occurs when the barrel of oil is "sold";[141] however, when oil is removed from a property before it is sold, the removal rather than the sale apparently triggers the tax.[142] This situation typically occurs when oil is stored or transported before sale. In addition, the tax would apply when oil is removed from the property and *used* in exploration, development, drilling, or extraction processes. The Conference Committee Report provides, however, that oil returned to the property from which it came, either by reinjection or through the powering of production processes or equipment, is not considered sold or removed from the premises.[143] Therefore, no tax is imposed on the onsite use of oil to generate power for an artificial life device, or a

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138. *Id.*
139. *Id.* at 103.
140. I.R.C. § 4996(b)(7)(B). Taxable period also means "March 1980." *Id.* § 4996(b)(7)(A).
141. *Id.* § 4988(c).
142. *Id.* § 4988(c)(3).
143. CONFERENCE REP., *supra* note 14, at 108.

water flood project, or a tertiary injection process.[144] According to the Committee Report, powerhouse fuel produced on one section of a single undivided piece of land is not taxable if it is used on another section of the same land and never leaves the land on which it is produced.[145]

The event that triggers the tax is not necessarily the "removal" or "sale" of the oil. When an integrated company removes and refines the oil, the tax is triggered by commencing the manufacturing or conversion process.[146] If the oil is transferred to a related party,[147] the transfer is treated as a sale, the triggering event.[148] If the oil is removed before transfer to the related party, however, the removal triggers the tax.[149]

As the preceding discussion suggests, what events constitute a "removal" or a "sale," as well as the order in which they occur, are crucial determinations under the windfall profit tax. Oil removed before it is sold is taxed at its "removal price";[150] oil sold before it is removed is taxed at its sales price.[151] Although not specifically defined in the Act, the term "removal" probably means extracted from the ground.[152] The term "sale," also not defined under the Act, takes its common and ordinary meaning under the Internal Revenue Code.[153] Under basic contract principles, a sale occurs when a written contract is signed by both parties and is otherwise legally binding.[154] Under the Uniform Commercial Code, a "sale" is defined as the passage of title from the seller to the purchaser for a price.[155] In the case of oral contracts, as is frequently the case in so-called "spot purchases," the Statute of Frauds may preclude enforcement until *delivery* of the product. Under the Securities Exchange Act, "time of sale" has been defined as occurring on the

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144. *Id.*

145. *Id.*

146. I.R.C. § 4988(c)(4).

147. "Related Parties" under § 4988(c)(2) are the same as under § 103(b)(6)(C), *i.e.*, such persons whose losses would be disallowed on exchanges between them under § 267 or § 707(b), or if these persons are members of the same controlled group of corporations as defined in § 1563(a) (except that "more than 50%" is substituted for "at least 80%" in each place in which the latter percentage appears in § 1563(a)).

148. I.R.C. § 4988(c)(2).

149. *Id.* § 4988(c)(3).

150. *Id.* § 4988(c).

151. *Id.*

152. *Id.* § 613.

153. *See generally* Boone v. United States, 470 F.2d 232, 235 (10th Cir. 1972).

154. *See* 1 A. CORBIN, CONTRACTS § 97 (1963).

155. U.C.C. §§ 2-106, 2-204.

date the proceeds are received.[156] The Treasury regulations will have to clarify what constitutes a sale and when it takes place under varying circumstances. Presumably, however, one need not undertake an intricate legal analysis each time a sales transaction takes place.

F. *Removal Price*

After determining the triggering event, one must determine the "removal price," usually the price at which the oil is sold to a third party purchaser.[157] But when the oil is removed before sale, transferred to a related party, or refined by an integrated company, the "removal price" is the constructive sales price, as determined under section 613.[158] Generally, the constructive sales price is that which "most nearly represents the approximate price at which the taxpayers, in light of market conditions, could have sold [the oil]."[159] For this purpose, the taxpayer's own actual sales of oil of like kind and grade may be taken into account.

Controversies will certainly arise over what exactly constitutes the sales price (*e.g.*, contract price, price actually paid, or some other amount). In variable price contracts, typically found in supply contracts in the petroleum industry, the "removal price" may be particularly difficult to determine. Under these contracts, the price fluctuates according to extrinsic price mechanisms, such as published postings and quotations, or other future price determinants, such as the cost of the product to the seller. Consequently, although variable price contracts, like fixed price contracts, are binding on the date entered into, the price under a variable price contract may not be determinable without reference to such future events as the date of delivery or the date of the customer's purchase order. It is unclear in such circumstances what the removal price would be.

Similar difficulties in calculating sales price may occur in other circumstances. Questions may arise over whether transportation costs and other expenditures should be part of the sales price. Section 613 and the energy rulings could provide guidance here. The Senate Committee Report points out that the sales price under an advance payment contract may not reflect the fair market value of

156. *See* Brenner v. Career Academy, Inc., 467 F.2d 1080, 1085 (5th Cir. 1972).
157. I.R.C. § 4988(c)(1).
158. *Id.* § 4988(c)(2)-(4).
159. Treas. Reg. § 1.613-3 (1979).

the barrels sold, when, for example, a large discount is permitted for the advance payment.[160] This Report also mentions that a producer may sell oil along with other goods or services without properly allocating the sales proceeds between the oil and the other goods and services. In all of these cases, the IRS has the authority[161] to adjust the removal price so that it reflects the market value of the oil.

G. *Base Price*

The Act applies the tax rate[162] to the removal price of the barrel of oil, less the sum of the base price (adjusted for inflation) and the severance tax adjustment. The base price is usually the price at which the particular type of oil was sold under 1979 energy price controls. Thus, the base price for Tier 1 oil is the "ceiling price which would have applied to such oil under the March 1979 energy regulations if it had been produced and sold in May 1979 as upper tier oil, . . . reduced by 21 cents."[163] Under this rule, all oils falling in Tier 1 will have the benefit of an "upper tier" ceiling price as the base price. Those producers of Tier 1 oil who did not previously produce upper tier oil, however, will have the problem of determining which upper tier ceiling price now applies to them.

Under the energy regulations, the ceiling price for upper tier oil consists of the highest posted field price for uncontrolled oil on September 30, 1975, less $1.32 plus certain post-1975 increases intended to offset inflation.[164] Thus, there are three important components of this ceiling price: the "posted price," the "field," and the "inflation adjustment." To qualify as a "posted price," the price must be published in writing by a purchaser of a substantial volume of crude oil in the field.[165] What constitutes "substantial" is not specifically defined. Under the energy regulations, "posted price" is defined as "a written statement of crude oil prices circulated publicly among sellers and buyers of crude oil in a particular field in accordance with historic practices, and generally known by sellers and buyers within the field."[166] A 1977 ruling[167] also indi-

160. S. Rep., *supra* note 23, at 65.
161. I.R.C. § 4996(f).
162. *See* notes 75-101 and accompanying text *supra*.
163. I.R.C. § 4989(c).
164. Mandatory Petroleum Price Regulations, 10 C.F.R. § 212.74 (1980).
165. Conference Rep., *supra* note 14, at 96.
166. Mandatory Petroleum Price Regulations, 10 C.F.R. § 212.31 (1980).
167. 41 Fed. Reg. 3628 (1977).

cates that "a letter from a purchaser to all crude oil producers in a field or in an area would constitute a posted price if the letter was understood by producers and the purchaser to be a bona fide offer to purchase from all producers in that field or area."[168] The Conference Committee Report points out, however, that a posted price does not include a "price offered by a purchaser who simply offers to buy oil at a figure (say) $1 higher than whatever prices are posted by the purchasers who are purchasing most of the oil in a particular oil field."[169] Because posted prices are frequently hard to identify, making administration of the price issue difficult, the Federal Energy Administration (FEA) issued but did not adopt a proposed manual in 1977, listing various posted prices for numerous U.S. fields.[170] The IRS may wish to continue this practice, since producers of other than upper tier oil will not have easy access to information about prices of upper tier oil in their fields.

The second component of the ceiling price is the field. "Field" is defined under FEA Ruling 1977-1 as follows:

> Specifically, the term field has different accepted meanings and usages in various producing areas, and consequently might have been interpreted to mean an area as small as a lease, or as large as one or more entire state [*sic*]. However, for purposes of posting crude oil prices, crude oil producers and purchasers have generally understood the term "field" to signify a general area underlain by one or more reservoirs. For example, while some price bulletins refer specifically to named fields in which the particular price prevails, other types of bulletins specify a price for a particular grade of crude oil, which is produced over a large geographical area—perhaps even over an area of one or more states.[171]

There seems to be great flexibility in determining the field. Producers will thus want to use the field that carries the highest price, so as to lower the windfall profit subject to tax.

The third component of the ceiling price is the inflation adjustment.[172] Unlike the Senate version of the windfall tax, the Act does not authorize the Secretary of the Treasury to modify the inflation adjustment under the code to conform to the inflation ad-

168. *Id.* at 3635.
169. CONFERENCE REP., *supra* note 14, at 96.
170. 42 Fed. Reg. 3628 (1977).
171. 42 Fed. Reg. 3636 (1977).
172. I.R.C. § 4989(b).

justment under the DOE regulations.[173] Consequently, another layer of calculations is added onto an already difficult computation.

The base price calculation under Tiers 2 and 3 is more difficult to determine than under Tier 1. The Act provides a temporary base price for Tier 2 and Tier 3 oil that fluctuates, depending on the grade, quality, and location of the oil. Section 4989(d)(2) establishes a temporary six-month rule for determining the base price for these two tiers of oil. There is also a minimum interim base price, which must not be less than the Tier 1 price, excluding the twenty-one cent reduction, plus $1 for Tier 2 oil and $2 for Tier 3 oil.[174] Congress intended the minimum base price to alleviate hardship for oil produced in areas where the posted prices on December 1979 were much lower than the national average and not typical of that field.[175] If the minimum rule does not apply, the base price will be the highest posted price for December 31, 1979, for uncontrolled crude oil of the same grade, quality, and field, multiplied by a fraction.[176] As with the Tier 1 base price, the posted price and field are important, and one must determine grade and quality. If there is no posted price for the field in question, one must use the nearest domestic field for which prices for oil of the same grade and quality were posted for December 31, 1979.[177] To prevent purchasers or producers from raising base prices artificially by increasing posted prices retroactively for December 1979, the tax precludes taking into account postings made after January 14, 1980.

Once one determines the highest posted price, it is multiplied by a fraction: the denominator of this fraction is $35, and the numerator is $15.20 in the case of Tier 2 oil, or $16.55 in the case of Tier 3 oil.[178] The purpose of this formula is to achieve an array of base prices so that oil of national average grade, quality, and location (excluding North Slope Alaskan Oil) will have a base price of $15.20 or $16.55, and oil of above or below average grade, quality, and location will have a proportionately higher or lower base price. According to the Conference Committee Report, data on December 1979 prices for uncontrolled oil posted as of January 14, 1980, suggest that $35 is the proper denominator to achieve the desired re-

173. S. REP., *supra* note 23, at 65.
174. I.R.C. § 4989(d)(3).
175. CONFERENCE REP., *supra* note 14, at 96 (California is an example).
176. See text accompanying notes 178-180 *infra*.
177. I.R.C. § 4989(d)(2)(A)(ii).
178. *Id.* § 4989(d)(2)(B).

sult. This report recognizes that the $35 figure is based on preliminary data for prices for December 1979, posted as of January 15, 1980, and states that other data may be available later in 1980 that would permit the Secretary to make a better estimate.[179] Congress acknowledges that the interim rule may not lead to a situation in which the price of Tier 2 and 3 oil of national average grade, quality, and location equals $15.20 or $16.55, and that the rule may not be equitable for all categories of oil. To correct this, "the Secretary may determine, after analyzing the data, that a formula based on actual selling price, not posted prices, would be more accurate."[180]

H. *Base Price Adjustment*

All base prices are adjusted for inflation on a quarterly basis after June 30, 1979, using the GNP deflator.[181] This adjustment uses the first revision of the price deflator that becomes available in the third week of the second month following the close of the quarter. For the first tax period, the *first quarter* of 1980, the adjustment equals the inflation between the second quarter of 1978 and the third quarter of 1979. Thereafter, the adjustment lags over two quarters. For example, in the *second quarter* of 1980 the adjustment will equal the inflation between the second and fourth quarters of 1979. Since the Act does not allow the Secretary to modify the inflation adjustment to conform to DOE pricing inflation adjustments, Tier 1 oil must be adjusted twice for inflation, once for the base price and again under section 4989.

Under section 4989(b)(2), Tier 3 oil receives an added inflation adjustment. In effect, this adjustment is equivalent to a two-percent "kicker" compounded quarterly[182] and is intended to provide an additional incentive for producers to explore for new oil and produce heavy and incremental tertiary oil.

I. *Severance Tax Adjustment*

In computing the taxable windfall profit, the taxpayer may deduct state severance taxes imposed on the profit portion of the price of a barrel of oil (the difference between the selling and the adjusted base price).[183] According to Congress, this adjustment is

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179. CONFERENCE REP., *supra* note 14, at 96.
180. *Id.*
181. I.R.C. § 4989(b).
182. *Id.* § 4989(b)(2).
183. *Id.* § 4996(c). The amount of the severance tax taken into account is limited to

necessary to avoid unduly burdening all producers when the combined effects of the windfall profit tax, the severance tax, and state and federal income taxes are taken into account.[184]

For purposes of the windfall profit tax, a state severance tax is one levied by a state (not a political subdivision) on extracted crude oil and calculated as a percentage of the gross value of the oil extracted.[185] Any state tax meeting this definition, regardless of its official name or title, is treated as a severance tax. Taxes levied on the value of reserves or on net proceeds from production or on each unit of production as a fixed fee per barrel do not constitute severance taxes.[186] The severance tax adjustment will still be available even if the tax does not technically apply to a particular type of oil. For instance, some states do not apply a severance tax to newly discovered oil or to royalty oil paid to the federal or state governments. As long as the severance tax applies to the entire price of those barrels subject to the tax, a severance tax adjustment is available.

To discourage states from raising severance taxes at the expense of the federal treasury, the Act provides that any increase in the rate of state severance tax after March 31, 1979, can be taken into account only if the increase applies to the entire price of a barrel of oil.[187] A similar rule applies if a state tries to impose or change a fixed fee tax to a percentage of gross value of oil removed.[188] The tax will be taken into account only if it applies to the entire price of a barrel of oil.

J. *Taxable Income Limit*

To determine the "windfall profit," one must make a computation under section 4988(a) and under section 4988(b). This latter section provides that the "windfall profit" on a barrel of oil may not exceed 90% of the net income attributable to that barrel.[189] Determining this limit involves three steps. First, the taxpayer must establish the property on which the crude oil is produced. Next, he must calculate the net income or taxable income from the property attributable to the barrel of oil. Finally, he must calculate

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15%. *Id.* § 4996(c)(3)(A).

184. *See generally* H. Rep., *supra* note 22, at 35.

185. I.R.C. § 4996(c)(2).

186. *Id.* (by implication).

187. *Id.* § 4996(c)(3)(B).

188. *Id.*

189. *Id.* § 4988(b)(1).

an imputed cost depletion deduction.

For purposes of section 4988(b), "property" has the meaning given it under section 614, not the meaning given it under the price controls.[190] Under section 614(a), property means each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land. For purposes of this definition, tracts or parcels may be considered separate if obtained by separate conveyances or if noncontiguous.[191] Contiguous areas acquired at the same time from the same owner constitute a single tract or parcel of land. Thus, separate reserviors could constitute a single property even though considered separate properties under the pricing rules. Areas included in separate conveyances or grants from separate owners are considered separate tracts or parcels, even if the areas are contiguous.[192] "Property" includes working or operating interests, royalties, overriding royalties, production payments, and net profit interests.[193] Because the definition of property under section 4988 differs from that used under the price controls, companies must keep an additional set of records to calculate the "windfall profit" and thus the windfall profit tax.

The net income or taxable income under section 4988(b) is calculated as it is under section 613(a), relating to percentage depletion, but with certain modifications.[194] Taxable income from the property equals gross income less allowable deductions.[195] Deductible items include operating expenses, certain selling expenses, administrative and financial overhead, depreciation, deductible taxes, losses sustained, intangible drilling and development costs, exploration and development expenditures, and other similar expenditures.[196] For purposes of section 4988(b), this taxable income is calculated as in section 613 but without deductions for intangible drilling and development costs or the windfall profit tax.[197] In lieu of these deductions, the Act allows an imputed cost depletion deduction, the calculation of which depends on whether the producer uses percentage or cost depletion. If a producer actually capitalizes intangible drilling costs for income tax purposes, he may reduce his

190. S. Rep., *supra* note 23, at 52.

191. Treas. Reg. § 6.614-1 (1961).

192. *Id.*

193. *Id.*

194. I.R.C. § 4988(b)(3)(A).

195. Treas. Reg. § 1.613-5(a) (1960).

196. *Id.*

197. I.R.C. § 4988(b)(3). Deduction of costs incurred in drilling an unproductive well, however, is allowed. *Id.*

taxable income from the property by the amount of the deduction under section 611[198] (either as cost depletion or as depreciation).[199] If the producer used percentage depletion for the property for all periods during which he owned an economic interest in it, the producer's taxable income is reduced for cost depletion, which would have been allowable if all intangible drilling costs incurred by the taxpayer on the property had been capitalized and taken into account in computing the depletion.[200] In contrast to the provisions of the House[201] and Senate Reports,[202] the Act allows the producer to treat qualified tertiary injectant costs as if they had been capitalized and recovered through cost depletion.[203]

To prevent producers from transferring low cost properties in order to enable transferee producers to obtain an increased basis (which could increase the cost depletion deduction and thus reduce taxable income for purposes of the 90% limitation), the Act provides that transferee producers may take into account only the amounts that would have been allowable to the transferor and the costs actually incurred during periods after the transfer.[204]

III. Administrative Provisions

A. *Withholding*

When taxable domestic crude oil is sold, the "first purchaser" is usually responsible for withholding the windfall profit tax.[205] The first purchaser must also compute the tax, deposit it, provide information statements, and file quarterly returns.[206] If, however, the oil is removed before its sale under section 4988(c)(3), transferred to a related party under section 4988(c)(2), or converted by an integrated producer-refiner under section 4988(c)(4), no withholding is required. In such circumstances, the producer must compute the tax, deposit it, and file quarterly returns.[207]

To compute the windfall profit tax, the purchaser needs cer-

198. Treas. Reg. § 1.611-0 (1968).
199. I.R.C. § 4988(b)(3).
200. *Id. See also* S. Rep. *supra* note 23, at 59.
201. H. Rep., *supra* note 22, at 37.
202. S. Rep., *supra* note 23, at 59.
203. I.R.C. § 4988(b)(3)(E).
204. I.R.C. § 4988(b)(4).
205. *Id.* § 4995(a)(1).
206. *Id.* § 4995.
207. I.R.S., Instructions for Form 6047, at 2. If the purchaser is not a domestic corporation, the producer would probably be the party responsible for computing and depositing the tax and filing the return.

tain information from either the producer or the operator. An operator is the company or group hired by the owners of the economic interest to manage, operate, and market the crude oil. The operator, on behalf of the economic-interest holders, handles the sale of their shares of production. The proceeds from a sale may be disbursed either directly from the purchaser to the various economic-interest holders or indirectly from the purchaser to the operator and then to the economic-interest holder. Whether an operator or a mere producer markets the crude oil, he must certify the following information to the first purchaser: 1) the tier in which the oil is taxed;[208] 2) the amount of the oil sold; 3) the property from which the oil was removed; 4) the adjusted base price of the oil; 5) the severance tax adjustment; 6) the amount of any exempt production; 7) whether the property is exempt;[209] 8) whether the oil is subject to reduced rates for independent producers; 9) if the producer of the oil is an integrated oil company, the portion of the oil produced by the integrated oil company; and 10) other information required by regulations.[210] The operator or producer must certify this information to the purchaser by the fifteenth day of each calendar month during which the oil was removed.[211] The operator, if one exists, must certify to the owner of the economic interest the same information certified to the purchaser. Section 6050C, however, authorizes the Secretary of the Treasury to provide by regulations that the operator and the purchaser may elect to relieve the operator of this certification requirement.[212] Similarly, they may jointly elect to have the operator assume the purchaser's withholding and depositary responsibilities under section 4995.[213]

Once the essential information is furnished, the tax can be calculated, withheld, and deposited. The party responsible for com-

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208. For Tier 3 oil, the operator or producer must certify whether the oil is newly discovered oil, heavy oil, or incremental tertiary oil. *Id.* at 3.

209. Oil exempt from the windfall profit tax because the producer is a state, an Indian, or a charity is not subject to withholding if the first purchaser receives an appropriate certification. CONFERENCE REP., *supra* note 14, at 113.

210. I.R.C. § 6050C; I.R.S., Instructions for Form 6047, at 3.

211. I.R.S., Instructions for Form 6047, at 3.

212. I.R.C. § 6050C(b).

213. *Id.* § 4995(a)(7). If the operator assumes these responsibilities, arguably the liabilities would be transferred as well. If they make this election, the timing of the deposit would depend upon the identity of the first purchaser and operator. Unless the operator is a major oil company, the operator would have to deposit the withheld tax (or estimated tax) at the same time the purchaser would have had to make deposits or estimated tax payments. Thus, if the purchaser is an integrated oil company, the deposit and estimated tax rules for integrated companies will apply to the operator.

puting the tax must file Form 6047, a quarterly return showing the amount of oil purchased for the year, the windfall profit tax withheld, and the tax deposited. The return is due by the last day of the second month after each taxable quarter.[214] The fourth quarter return, for instance, is due by March 1 of the following year.

Any purchaser or operator subject to the withholding rules must file both monthly[215] and annual[216] informational statements that provide each producer with information on the amounts of oil purchased and the tax withheld. A purchaser who buys oil from a partnership must supply information on oil produced by the partnership as a whole. The partnership return will provide information on each partner's share of the production. The Secretary of the Treasury may require additional returns and information exchanges.

The timing of the withholding deposit depends upon the identity of the party responsible for withholding the tax. Integrated oil companies must make semi-monthly deposits of the estimated amount of the withholding tax.[217] All others, specifically independent producers,[218] must make withholding deposits not later than forty-five days after the close of the month in which the oil is removed from the premises. A sixty-day deposit rule applies for independent refiners who purchase oil under a delayed payment contract. For those who do not withhold by the time prescribed, the safe harbor rules of Treasury Regulations section 48.6302(c)-1 apply.[219]

The purchaser (or operator, if the operator has assumed the purchaser's responsibilities) is liable to the Treasury for payment of the amount required to be withheld. The purchaser is not, however, liable to the producer for this amount. If an error results from improper certification by an operator or producer, the pur-

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214. I.R.S., Instructions for Form 6047, at 2.

215. The purchaser or operator must give the monthly statement to the producer before the first day of the second month after the month in which the oil is removed. *See id.* at 3.

216. The purchaser must file Form 6248 for each producer and for the IRS by January 31 of the year following the calendar year to which the information relates. *See id.* at 4.

217. I.R.C. § 4995(b)(1). An integrated oil company for purposes of this section is defined as a taxpayer described in paragraph (2) or (4) of *id.* § 613A(d) who is not an independent refiner. *Id.* § 4995(b)(3).

218. Independent refiners for purposes of section 4995(b) are defined as they are under paragraph (3) of section 3 of the Emergency Petroleum Allocation Act of 1973 (as in effect on January 1, 1980) except that the "preceding calendar quarter" is substituted for "November 27, 1973" in applying that paragraph. *Id.* § 4995(b)(4).

219. CONFERENCE REP., *supra* note 14, at 113.

chaser is generally not responsible. If, however, the purchaser participates in the misrepresentation, has reason to believe the certification is improper, or is negligent in satisfying his obligations, he may be liable.[220] Treasury Regulations are to provide guidelines for withholding when no certification exists or when the purchaser has reason to believe that the information contained in the certification is false.[221] Under such circumstances the purchaser would at least know the quantity of the oil, as well as its grade and quality, and could probably refer to agency-published charts for base prices. An interim rule given in the instructions for Form 6047 prescribes two methods of calculating the tax if the producer or operator provides no certification.[222] The Conference Committee Report states that to encourage the furnishing of information, the regulations may require withholding at the maximum possible tax on any particular oil even though such tax exceeds the amount that would have been due if a proper certification had been made.[223] If an incorrect amount of the tax is withheld, an adjustment may be required.[224] To correct earlier withholding errors, a producer may voluntarily authorize a purchaser to withhold tax on oil removed later in the calendar year.[225] The Act also authorizes the Secretary of the Treasury to allow adjustments after the year ends.[226] If a correction to the withholding must be made because the windfall profits tax would be less under the 90% net income calculations, the purchaser (or producer) must wait until the end of the year for a refund.[227] If the correct amount of tax is withheld,

220. *Id.* at 112.

221. *Id.*

222. I.R.S., Instructions for Form 6047, at 5. Withholding may be computed at the purchaser's option for the period April 18, 1980, through June 3, 1980, under any of three methods. The first method is on the basis of information provided by the operator when the purchaser has no reason to believe that information is incorrect. If the purchaser has reason to believe the information on the certificate is false, the purchaser may use the second method and compute the tax as follows: 1) if the purchaser pays lower tier prices for the oil, no windfall profit is withheld; 2) if the purchaser pays upper tier or uncontrolled prices for the oil, the tax is computed by using $11.01 as the base price for the oil, and completing the computation using the applicable inflation adjustment and severance tax adjustment, if known. The rate of tax is 70% under this method. Purchasers may use only these two methods for oil bought after June 3, 1980. Method three allows the purchaser to compute the withholding by taking 70% of the excess of the removal price of the oil over $11.22 ($11.47 for oil removed after March 31, 1980). *Id.*

223. CONFERENCE REP., *supra* note 14, at 112.

224. I.R.C. § 4995(a)(3). This adjustment is limited to the amount of the windfall profit on the oil. *Id.* § 4995(a)(3)(C).

225. *Id.* § 4995(a)(3)(D).

226. *Id.* § 4995(a)(3)(A).

227. *See id.* § 4995(a)(2)(B).

the producer of the oil need not file a tax return. The producer is deemed to have paid on the last day of February of the year following that in which the oil was removed.[228]

B. *Sanctions*

Certifying false information, failing to deposit the correct amount of the windfall tax, or otherwise not complying with the obligations imposed by the windfall profit tax can result in substantial sanctions against the purchaser, producer, or operator. These sanctions include the civil and criminal sanctions contained in the Internal Revenue Code, as well as special sanctions provided by new section 7241. By a fine (up to $10,000) and by imprisonment (up to one year), section 7241 punishes as a misdemeanor the willful failure to comply with the obligations imposed under section 6050C and the regulations thereunder. The following general civil and criminal penalties can also apply: 1) a 5% addition of the amount of the tax per month for failure to file (25% limit);[229] 2) a $1 charge per information return not filed ($1,000 limit);[230] 3) a 50% addition to the amount of the tax for fraudulent underpayment;[231] 4) a 5% penalty for underdeposit;[232] 5) a 100% penalty for willful failure to collect or pay over any tax;[233] 6) a $10,000 fine or a five-year prison sentence or both, for a willful attempt to evade tax;[234] 7) a $10,000 fine and/or a five-year prison sentence for willful failure to collect or pay over tax;[235] 8) a $10,000 fine or a one-year prison sentence or both, for willful failure to file returns, supply information, or pay tax;[236] and 9) a $5,000 fine or a three-year prison sentence or both, for false or fraudulent statements.[237]

228. *Id.* § 4995(a)(4).
229. *Id.* § 6651.
230. *Id.* § 6652(b).
231. *Id.* § 6653(b).
232. *Id.* § 6656.
233. *Id.* § 6672.
234. *Id.* § 7201.
235. *Id.* § 7202.
236. *Id.* § 7203.
237. *Id.* § 7206. In addition, the general rule of tax law that places the burden of proof on the taxpayer in a civil proceeding is adopted by the Act. Thus, a taxpayer must be prepared to establish the various items upon which the windfall profit tax liability is predicated, including the classification and base price of the oil sold and the category to which the producing property belongs. *See* S. REP., *supra* note 23, at 67.

C. *Court Jurisdiction*

The House bill contained no provision relating to the jurisdiction over controversies involving the windfall profit tax. Generally, matters involving an excise tax would be within the jurisdiction of the district courts of the United States and the Court of Claims but not within the jurisdiction of the United States Tax Court.[238] The Senate amendment proposed that the Tax Court have exclusive jurisdiction in controversies over the windfall profit tax[239] to provide taxpayers "with a prepayment forum in which to litigate issues involving the tax" when an "expert tribunal" could "resolve issues in an efficient, expeditious, and uniform manner, regardless of the location of the taxpayer or the oil."[240] Furthermore, litigants could use the simplified procedural rules of the Tax Court.

The Act itself provides no special jurisdictional rules. Jurisdiction over liability under the withholding provisions will be in the district courts and the Court of Claims.[241] When the IRS asserts deficiencies in the windfall profit tax, the Tax Court will have jurisdiction in the case of prepayments, and the district courts and the Court of Claims will have jurisdiction over refund suits.[242] The Temporary Emergency Court of Appeals, which had jurisdiction over the energy pricing legislation, is given no jurisdiction under the Act. Appeals will therefore lie, as in the usual tax case, in a United States Court of Appeals.

IV. USE OF WINDFALL TAX FUNDS

In place of the trust funds and reservations proposed in the House[243] and Senate bills,[244] the Act provides that the Treasury allocate the net revenues from the windfall profit tax to a separate account.[245] This separation is for accounting purposes only, since the funds are not to be earmarked or invested separately from the general revenue.[246] Congress recommended, however, that parts of the revenue be used for special purposes, which will require annual

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238. L. PONDER, UNITED STATES TAX COURT PRACTICE AND PROCEDURE 25 (1976).
239. S. REP., *supra* note 23, at 69.
240. *Id.*
241. CONFERENCE REP., *supra* note 14, at 115.
242. *Id.*
243. H. REP., *supra* note 22, at 47.
244. S. REP., *supra* note 23, at 124.
245. CONFERENCE REP., *supra* note 14, at 117.
246. *Id.*

Congressional authorization and appropriation.[247]

"Net revenues" from the windfall profit tax are equivalent to the gross amount of windfall profit tax collected (other than from oil owned by the United States) less the amount of income tax generated by the windfall tax.[248] The projected net revenues over the next ten years are $227.3 billion, allocated for the following purposes: 1) 25% for aid to lower-income households; 2) 60% for individual and corporate income tax reductions; and 3) 15% for energy and transportation spending programs.[249] If the windfall profit tax takes in more than the expected revenues, the Act allocates two-thirds of the excess to income tax reductions and one-third to lower-income assistance.[250] No specific allocation exists for the synthetic Fuels Corporation because, as the Committee Report states, the outlays for such a program are uncertain both in timing and in amount.[251] In the future, however, Congress could allocate a portion of the windfall tax fund to this purpose.

Incorporated into the same legislation that adopted the windfall tax is a low-income energy assistance program.[252] This program authorizes $3.1 billion for fiscal 1981 for block grants to the states to help lower-income families pay the costs of heating and cooling their homes. Unlike the Senate version,[253] the Act does not authorize assistance funds after 1981. The $3.1 billion figure represents twenty-one percent of the projected $14.719 billion expected to be generated by the tax in 1981.[254] This percentage closely approximates the amount Congress intended to allocate for that purpose.

In addition to aiding the poor, the Act aids homeowners[255] and businesses.[256] Many of these measures are tax credits for purchases of solar, geothermal, or other non-oil burning equipment. In other measures unrelated to energy altogether, the Act repealed the carryover basis,[257] provided an interest and dividend exclusion,[258] and

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247. *Id.* at 118.
248. *Id.* at 163.
249. *Id.* at 117.
250. *Id.*
251. *Id.*
252. Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, §§ 301-13, 94 Stat. 229.
253. S. REP., *supra* note 23, at 112-17.
254. FACT SHEET, *supra* note 3, at 27.
255. *See* Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, § 202, 94 Stat. 229.
256. *See id.* § 221.
257. *Id.* § 401 (amending I.R.C. § 1023).
258. *Id.* § 404 (amending I.R.C. § 265(2), I.R.C. § 854(b) respectively).

granted relief for involuntary liquidations of LIFO inventories[259] and taxation of inventory profits at corporate liquidations.[260] Over the next decade, these tax measures will cost the Treasury $15.7 billion.[261] The residential energy tax credits will cost $600 million; the business energy tax incentives will cost $8.3 billion; the carryover basis provision will cost $4.3 billion; the LIFO liquidation provision will cost $250 million; and the inventory profits provision will cost $2.25 billion.[262] These figures hardly make a dent in the $136.4 billion expected to be generated under the tax for this purpose.[263]

Although Congress provided in the Act for aid to the poor, homeowners, and businesses, it made no proposals for the "energy and transportation program," for which 15% of the tax funds are allocated. There was considerable dispute over this program in the committee hearings, for the legislators apparently felt that creating a bureaucratic structure to disseminate funds for transportation and other programs would be too costly. If Congress fails to enact legislation that uses the windfall tax, the Conference Committee Report stipulates that the revenue will be used to reduce the federal deficit.[264]

After fiscal year 1980, the Act requires the President to propose for each year an allocation of the net revenues from the windfall profit tax among the specified purposes. For fiscal year 1981, he must submit the proposal within ninety days after enactment; for succeeding fiscal years, he must include the proposal in the annual budgets. Beginning in fiscal year 1982, the Secretary of the Treasury will report annually to Congress on the net revenue derived from the windfall profit tax for the preceding fiscal year and the actual disposition of these revenues for the various specified purposes.[265]

V. EFFECTS OF THE TAX ON THE ECONOMY

Under section 103 of the Act, the President must submit a report to Congress by January 1, 1983. This report will describe the effect of decontrol and the windfall profit tax upon domestic oil

259. *Id.* § 403 (adding I.R.C. § 473).
260. *Id.*
261. FACT SHEET, *supra* note 3, at 27.
262. *Id.*
263. *Id.*
264. CONFERENCE REP., *supra* note 14, at 118.
265. Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, § 102(e), 94 Stat. 229 (1980).

production, oil imports, oil company profits, inflation, employment, economic growth, federal revenues, and national security.

Although it is impossible to predict accurately the impact of the windfall profit tax on these areas, certain estimates of its impact on various items have been made. One source, for example, estimates a 1.6 million barrel per day reduction in domestic production of crude oil by the late 1980's as a result of the tax.[266] Another study predicts only a slight decline in oil imports.[267] The same study estimates that a 60% windfall profits tax would add an additional .1% per year to the rate of inflation by 1985, would increase the unemployment rate by .4% by 1985, and would lower the rate of growth of the United States economy.[268]

Decontrol of oil prices is expected to generate $1.025 billion in oil company revenues by 1990.[269] According to one estimate, in the absence of a windfall profit tax the federal government would take 35% of this revenue through the federal income tax and through royalty payments on federally-owned land.[270] State and local taxes and royalties would absorb 13.3% of the revenues, leaving the oil companies with 51.7% of the revenues.[271] With the windfall profit tax, however, it is estimated that the oil companies will retain only 22% of the increased revenue.[272] The tax is expected to raise federal revenues by $227.7 billion over the twelve-year period (1979 through 1990), less tax reductions of $15.5 billion, leaving a net gain of $212.2 billion.[273]

VI. Tax Policy Analysis and Comment

Whether or not the new windfall profit tax reflects good tax policy depends on a number of factors: 1) Is the tax comprehensible? 2) Can it be effectively enforced by the IRS? 3) Is the tax equitable? and 4) Will it accomplish the purposes for which it was enacted—increasing domestic production and promoting energy in-

266. Crow, *U.S. House Passes Excise Tax on Decontrol Revenues*, Oil & Gas J., Mar. 17, 1980, at 59.

267. Evans Economics, Inc., The Economic Impact of Oil Price Deregulation and the Windfall Profits Tax, *printed in Hearings on Windfall Tax Before the Senate Finance Comm.*, 96th Cong., 1st Sess. 812 (1979) (Statement of Michael K. Evans).

268. *Id.* at 789.

269. Fact Sheet, *supra* note 3, at 3.

270. *Id.*

271. *Id.*

272. Crow, *Excise Tax Top Issue on Lawmakers' Energy Slate*, Oil & Gas J., Jan. 7, 1980, at 36.

273. Conference Rep., *supra* note 14, at 163.

dependence? President Carter, in proposing the windfall tax, stated:

> The tax is designed to reduce to the greatest possible extent the complexity and excessive regulation associated with existing price control mechanism . . . . For purposes of administering the tax it will no longer be necessary to police the price at which oil and oil products are sold. The records that are to be kept will, in large part, be the same records that taxpayers are required to retain for income tax purposes. Finally, because the volume of oil at the lower tier and the upper tier base price will both phase out, only a simple tax will remain in place permanently.[274]

Contrary to the President's statements, the complexity of the energy regulations will not end with decontrol and the new tax. Many of the DOE pricing rules are incorporated into the new tax, forming an essential part of it. It is true, however, that the new windfall tax is imposed only at the production level, whereas the DOE pricing system imposes controls on three levels of the oil industry—production, refining, and resale or retail. To this extent, the new law simplifies the existing price control structure. Also, the DOE crude oil production rules are only partially carried over to the windfall tax. In some respects, the Act simplifies these rules. Thus, various types of oil, such as old and new oil, are combined into one category or tier, negating the requirement of making difficult calculations to distinguish the oils. Nevertheless, many of the confusing and ambiguous definitions from the DOE pricing regulations remain. The problems associated with determining "property," "BPCL," "ceiling price," "highest posted price," "field," and the particular type of oil will continue to exist. Furthermore, the windfall profits tax adopts new and different definitions of certain types of oil, such as heavy oil and incremental tertiary oil, creating uncertainty about how the tax rules will interrelate with the energy rules.[275]

The windfall profit tax is not a simple tax. To determine the windfall profit, one must make two complex computations, one under section 4988(a) and another under section 4988(b). Each of these calculations contains numerous parts, and the parts themselves may be difficult to determine. For instance, the base price

274. 15 WEEKLY COMP. OF PRES. DOC. 722 (Apr. 26, 1979).

275. For example, it is unclear how the new tax will interrelate the DOE unitization rules and the new definition of incremental tertiary oil.

depends on the highest posted price, the field, and in the case of Tier 2 and Tier 3 oil, a comparison of similar grade and quality oils. The base price is then adjusted for inflation, the two-percent "kicker," and the severance tax. To complicate the calculation further, the property concepts differ under subsections (a) and (b) of section 4988—with one definition for the type of oil, and another for the net income limitation.

Contrary to the President's statements, the windfall profit tax will require taxpayers to keep records other than those kept for income tax purposes. Records similar to those necessary under the energy regulations are essential because the taxpayer must determine the property, the posted price, the field, and the type of oil. Because many of the concepts in the windfall profit tax are foreign to the existing income tax structure, taxpayers will have to maintain new records, which will include information on such things as "removal," "removal price," "base price," and "the inflation adjustment." To be sure, many of the records kept for income tax purposes will be necessary for determining the windfall tax. Thus, for example, "economic interest," "working interests," "net income," and "constructive sales price" will be determined as they are under sections 611 and 613 of the Code. But many of the definitions in the Code are defined differently in parts of the windfall profit tax. For example, "related party" is defined one way under section 4992 and another way under section 4986(c)(5). Similarly, the definition of "severance tax" in section 4994(a) differs from the definition in section 4989.

In addition to creating complicated rules that require detailed recordkeeping, the windfall profit tax creates enforcement problems. Under the new tax it will be necessary to police the price of oil. Two key components of the windfall profit tax, the "removal price" and the "base price," depend on computations that taxpayers may easily manipulate. A small change in either of these prices could cause a substantial change in tax liability. Recognizing this problem, Congress gave the IRS the power to adjust the removal price so that it will equal the fair market value.[276] Similarly, recognizing that the base price calculation may result in a figure unrelated to the 1979 controlled price of oil, the Conference Committee Report provided for authority in the Secretary of the Treasury to change the rules.[277] Notwithstanding such efforts to mitigate the

276. I.R.C. § 4995(f).

277. CONFERENCE REP., *supra* note 14, at 96.

effect of price discrepancies, the possibility of error, whether willful or not, will make policing necessary.

Various transfers by producers will also have to be monitored. The Code provides that crude oil produced from transferred property "shall not constitute oil from a stripper well property, newly discovered oil, or heavy oil, if such oil would not be so classified if the property had not been transferred."[278] This prohibition nullifies the advantage of transfers that would cause property to fall into less heavily taxed categories. In addition, the Code precludes producers from making transfers that would enable them to become independent producers eligible for a reduced tax rate.[279] Lastly, other transfer rules prevent companies from reducing their net income when calculating the 90% net income limit.[280] The purpose of these rules is to prevent the taxpayer from circumventing the windfall profit tax. Needless to say, many of these transfer rules will be difficult for the IRS to monitor.

In addition to the complexity of the tax and the necessity for policing it, several other problems require resolution if the IRS is to enforce the tax effectively. One serious problem is the lack of IRS expertise in the regulation of crude oil. Because the windfall profit tax is based in large part on the technical definitions of types of oil, calculations of controlled oil prices under DOE regulations, and the interrelationship of energy and tax rules, the IRS may be ill-equipped to clarify potential ambiguities. Moreover, the IRS may not have the appropriate procedural devices to deal with the problems that may arise under the new tax. Although the IRS has an agency process for making rulings, it does not have the exceptions procedure and other procedures available to the DOE. Finally, because of the technical nature of the tax, the courts may have difficulty interpreting the law. Disputes arising under the tax will not go to one specialized court, as proposed by the Senate Report, but to the district courts or to the Tax Court. Thus, when a dispute arises, there will be no clear voice describing the meaning of the windfall tax. Appeals will go to a United States Court of Appeals, also a nonspecialized court.

Although some features of the tax hinder its effective enforcement, others make enforcement easier. One positive feature is the requirement that the first purchaser compute, withhold, and de-

278. I.R.C. § 4996(e).
279. *Id.* § 4992(d)(3).
280. *Id.* § 4988(b)(4).

posit the tax. This requirement imposes upon an independent party the primary responsibility for enforcing the tax. Because the purchaser should have knowledge of the essential elements of the tax—the type of oil purchased, the amount of the purchase price, and even the base price (if the IRS continues the DOE tradition of publishing price schedules)—the computation should be accurate. Furthermore, purchasers have an incentive to comply with the tax because they themselves may be liable for the tax if the improper amount is withheld. Another positive feature of the tax is the fact that the IRS will be enforcing it. Past history of the IRS's enforcement procedures indicates that the IRS has successfully detected Code violations, aggressively prosecuted and pursued violators, and imposed penalties. Not only are all general civil and criminal sanctions available, but the windfall tax provides special sanctions, as well.

In addition to the problems of complexity and enforceability, the windfall profit tax creates some inequities. Because only domestic crude oil production is taxed, companies that import their oil will pay less tax than their counterparts who produce most of their oil domestically. Some of the tax burden is alleviated in the case of independent producers by the 1,000 barrel per day exemption. But the Act is arguably inequitable because it places the tax upon producers of oil rather than on refiners, retailers, or resellers. Many producers are individuals with royalty interests who, unlike larger corporate producers, are unable to pass the tax burden on to the purchasers.

The tax burden is heaviest on producers of Tier 1 oil, some of whom the tax may unfairly hurt. To help counter this, the Conference Committee Report, recognizing that high water-cut oil may be unfairly treated, gave the DOE authority to provide "special price treatment for this important category of oil."[281] Despite these efforts, however, some of the inequities with Tier 1 will remain, because all types of oil will receive the same base price, that of upper tier oil. Thus, producers of lower tier oil will have an added windfall, because their tax is not computed on a base price relevant to their controlled price in 1979. Many of these inequities result from the congressional attempt to simplify the tax structure, creating a trade-off between two of the objectives of good tax policy—equity and simplicity.

Perhaps the most important question to ask about a tax is

281. CONFERENCE REP., *supra* note 14, at 93.

whether it accomplishes the objectives for which it was passed. The windfall profit tax has two primary purposes: to increase production of domestic oil and to promote our energy independence. Although estimates indicate that the windfall profit tax will decrease domestic oil production,[282] decontrol without the tax would not generate the revenue essential for energy independence. The windfall tax is structured to promote the production of certain types of oil. For example, because most Alaskan oil is exempt from the tax, incentives exist to produce oil in Alaska despite severe climatic conditions. The special rates for Tier 2 and Tier 3 oil also create incentives for the discovery of new oil, for continued production from properties that produce only small amounts of oil, and for the production of heavy oil and incremental tertiary oil, which frequently require costly production methods. Since 98% of the nation's 12,000 independent producers produce less than 1,000 barrels of oil per day, the special independent producer rate should help mitigate any adverse effect the tax may have on their exploration and production activities.[283] Thus, the windfall tax, though not increasing overall production, does promote certain types of domestic oil production.

As to the second objective, energy independence, the Act includes no special "plowback provisions,"[284] no grant or loan programs for energy projects, and no establishment of a synfuel corporation.[285] Instead, large amounts of windfall profit tax revenues will go into tax reductions, most of which will not increase energy independence. The Act recommends 25% of the windfall revenue for aid to the poor; in 1981, 21% will actually go for this purpose. Sixty percent of the windfall revenue is recommended for individual and business tax reductions; yet thus far Congress has used only a small amount for this purpose. The Act allocates only 15% of the windfall revenue for transportation and conservation measures, but fails to establish any such program. If no tax incentives or energy programs are developed, the windfall funds will go to balance the budget, a measure that may strengthen the economy but will not promote our energy independence. Certainly, transportation, conservation, and other programs must be implemented to achieve this goal. It remains to be seen, however, whether Congress

282. *See* note 266 and accompanying text *supra*.

283. *Senate Passes Excise Tax Exemption*, OIL & GAS J., Dec. 3, 1979, at 38.

284. A "plowback provision" is a tax credit to the oil companies for profits reinvested in certain energy enterprises.

285. A synfuel bill is now before Congress.

will pass the needed legislation.

If the windfall tax is not the best way to accomplish our energy objectives simply, equitably, and effectively, the question becomes: What kind of tax would accomplish this? To be sure, Congress could enact numerous taxes that would generate revenue. A gasoline tax, a consumption tax, an import fee, or a tax on the profits of oil companies are four such measures. None of these taxes, however, would provide for selective incentives for the domestic production of oil. The consumption tax is a tax on the use of oil and gas and would directly affect conservation. Businesses (and possibly homeowners) would have an incentive to change from oil to coal, solar, wind, geothermal, or some other energy source. The gasoline tax could indirectly affect conservation, because it would be imposed on the consumer. The import fee would reduce imports. The net profit tax would apparently have no direct effect on either conservation or imports.

The gasoline tax would be relatively simple to administer. It would be a flat rate administered as it is now under state law. An import fee, depending on its structure, could create another administrative headache. President Carter's plan to impose an import fee was rather complicated because he intended it to affect only the price of gasoline.[286] Under his plan, the price of other types of imported crude oil remained unaffected. A tax geared to the net profits of a company or royalty owner, though easily administered, would be unfair. Because deductions of companies and individuals vary from taxpayer to taxpayer, the net profit would not necessarily reflect the income from oil production. The consumption or use tax could pose administrative problems, also. Congress considered such a tax,[287] but rejected it as inequitable to oil-producing states. The proposal was as complicated as the windfall tax, with special rates for certain users depending on which tier applied to them. The proposal included calculations of acquisition costs, target prices, process use exemptions, quantity exemptions, and credits.[288]

In a time when consumers are frustrated over the high price of energy and oil companies are garnering huge profits, the windfall profit tax seems to make sense. It returns some of the oil company revenues to the public in the form of grants and tax reductions.

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286. *Judge Rebuffs Carter, Blocks Oil-Import Fee,* Wall St. J., May 14, 1980, at 3.
287. H.R. 6831, 95th Cong., 1st Sess. §§ 1501-1503 (1977).
288. *Id.*

The tax is complex and flawed, but its problems are not insurmountable. The IRS, through detailed regulations, can clear up the relationship between the energy rules and the tax rules and can define the new ambiguous terms that are an essential part of the windfall calculation. The tax, though inequitable in some respects, is generally fair. Its combination of exemptions and reduced rates provides the necessary incentive for production of certain types of oil and for producers deserving of such preference. The biggest challenge under the tax will come in the future, as Congress establishes programs and tax measures designed to help us become energy independent.