TORCH OPERATING COMPANY 1221 Lamar Suite 1600 Houston, TX 77010,	§ §	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. MISC. 02-590
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed Torch Operating Company, Inc. ("Taxpayer") for oil and gas privilege and production ("severance") taxes for January 1999 through November 2001. The Taxpayer appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. A hearing was conducted on February 4, 2003. Duane Graham represented the Taxpayer. Assistant Counsel John Breckenridge represented the Department.

ISSUES

Alabama's oil and gas severance taxes are levied on the "value" of unrefined oil or gas at the "point of production," or wellhead. Code of Ala. 1975, §§40-20-2 and 9-17-25. This case involves the "workback" method for determining taxable value. The workback method is used when there is no sale of the product at the wellhead. "Value" is computed under the workback method by taking the sale price of the refined product, and then "working back" to the taxable value of the raw product at the wellhead by deducting the various post-production transportation, processing, and other costs incurred in refining the product into marketable form. See generally, *State v. Phillips Petroleum Co.*, 638 So.2d 886, 888 (Ala. 1992); *Esco Oil & Gas, Inc. v. State of Alabama*, Misc. 00-310 (Admin. Law Div. 5/8/01).

Department Reg. 810-8-6-.01 involves the workback method, and provides a general framework for computing taxable wellhead value under the workback method. Various provisions in the regulation relating to costs allowed under the workback method are at issue in this case. Those issues are:

(1) What percentage of the Taxpayer's "field labor" costs incurred in the subject period should be allowed under the workback method;

(2) What percentage of the Taxpayer's "overhead" costs should be allowed; and,

(3) Should the Taxpayer be allowed to include a return on investment in computing the actual cost of producing its fuel gas during the audit period.

FACTS

The Taxpayer operates a coal bed methane gas field, the Robinson Bend field, in Tuscaloosa County, Alabama. As the field operator, the Taxpayer reports and pays the Alabama severance taxes on the gas produced in the field on behalf of the various royalty and working interest owners in the field. The field covers approximately 75 square miles. It contains 394 wells, 8 compressor stations, 2 water facilities, and 1 central sales facility.

Each well in the field has a pump jack that brings the raw gas from the ground to the wellhead. The unrefined gas contains excess water and other impurities, and must be treated before it can be marketed. The gas is measured at the wellhead and moved through a flow line to a bulk water separator. The separated water is diverted to a storage facility. The gas then flows through the gathering pipeline to 1 of 8 compressor stations in the field. Impurities are removed by scrubbers, and the gas is compressed and run through a dehydration unit, where more water is removed. The refined gas then flows to the central

sales facility, where it is measured and sold.

The parties agree that because the Taxpayer's gas is not sold at the wellhead, taxable wellhead value must be computed using the workback method. As indicated, the dispute involves how three costs allowed under the workback method should be computed.

(1) Field Labor.

Reg. 810-8-6-.01(6)(b)3. allows a general labor expense under the workback method for processing-related labor. Although not mentioned in the regulation, the Department agrees that processing-related field labor is an allowed cost. Field labor involves both production-related and processing-related activities, and includes monitoring and maintaining the water disposal system, the gathering pipelines, the compressor stations, and the well sites. Work at the well sites includes checking the pump jack and the gathering pipes and valves, and reading and recording the sales allocation meter. As discussed below, the Taxpayer employed 23 field employees during the audit period.

The Department does not dispute the total field labor costs incurred by the Taxpayer during the audit period. The issue is what part of the total field labor was processing-related.

The Department had previously audited the Taxpayer on three occasions, for the period ending September 1992, for October 1992 through July 1994, and for November 1994 through June 1997. The Department allowed the Taxpayer 40 percent of its total field labor in one of the audits, and 100 percent in another audit. The Department allowed those estimated amounts without requiring the Taxpayer to provide records identifying the amount of processing-related field labor.

The Taxpayer deducted 70 percent of its monthly total field labor during the period in issue. The Taxpayer's tax preparer testified that the 70 percent figure was a compromise amount the Department had previously agreed to. He continued deducting the 70 percent during the period in issue because he was not told otherwise by the Department.

On audit, the Department disallowed the 70 percent deduction because (1) it disputed that it had agreed to the 70 percent deduction, and (2) the Taxpayer failed to provide records substantiating the 70 percent amount.

After rejecting the 70 percent amount, the Department estimated deductible field labor using a formula suggested by one of its auditors. The Department determined that the Taxpayer operated 7 compressor stations, and that all work at the compressor stations was deductible. It multiplied the number of compressor stations by 10 on the assumption that work at the compressor stations was 10 times more labor intensive than at the well sites. It also assumed that all work at the wells was nondeductible. By comparing deductible work at the compressors to nondeductible work at the wells, the Department computed deductible field labor to be 15.0862 percent of total field labor (total wells and compressor stations (464) divided into compressor stations (70) equals 15.0862 percent).[1]

[1] In computing the amount, the Department erroneously assumed that the Taxpayer had 7 compressor stations instead of 8. If the Department formula had correctly included 8 compressor stations, the percentage would have been approximately 17 percent.

Concerning the alleged 70 percent agreement, as indicated, the Department had allowed the Taxpayer 40 percent and 100 percent field labor deductions in two prior audits. Seventy percent is midway between 40 and 100 percent, which may or may not be a coincidence. However, there is no evidence supporting the Taxpayer's tax preparer's claim that the Department had agreed to the 70 percent amount. The Department's severance tax supervisor testified that he never agreed to a 70 percent deduction, or at least did not remember doing so.

Even if the Department had allowed the 70 percent amount in a prior audit, the Department would not be bound by that amount in the current audit. The Department regularly settles audits by compromising with taxpayers on various issues. The Department is not bound by a position taken in a prior audit if it is later determined that the prior position is incorrect and does not accurately reflect the taxpayer's liability. *Community Action Agency of Huntsville, Madison County, Inc. v. State*, 406 So.2d 890 (Ala. 1981) (the State cannot be estopped in the assessment and collection of taxes).

The Department also argues that the Taxpayer was required to maintain records identifying the deductible field labor, and that because it failed to maintain such records, "then the Department need not accept the approximations of Torch." Department's Post-Hearing Brief at 3.

All taxpayers are generally required to keep records sufficient "to allow the department to determine the correct amount of value or correct amount of tax. . . ." Code of Ala. 1975, §40-2A-7(a)(1). I agree that if a taxpayer fails to document a statutory deduction, a charitable deduction for income tax purposes, for example, the deduction must

be disallowed. *McDonald v. C.I.R.*, 114 F.3d 1194 (1997). But unlike income tax and other deductions granted by the Legislature, allowed costs, i.e. "deductions," under the workback method are not statutory deductions, nor do they serve to reduce an otherwise taxable amount. Rather, allowed costs are required components in the workback formula that the Department must consider in determining wellhead value for severance tax purposes. The Department is under an affirmative duty to calculate taxable wellhead value, including all allowed costs, and if a taxpayer fails to document an allowed cost, the Department must estimate the allowable amount using the best information available. "[T]he department may calculate the correct . . . value based on the most accurate and complete information reasonably obtainable by the department." Code of Ala. 1975, §40-2A-7(b)(1)a.

The Department, recognizing that some field labor must be allowed, attempted to estimate the Taxpayer's deductible field labor by using the formula discussed above. But that formula does not accurately identify processing-related field labor because it is based on several erroneous assumptions. For example, the formula assumes that all field labor at the 394 wells was nondeductible. As discussed below, a majority of the well-related field labor was post-production, and thus deductible.

The only evidence concerning the field employees' activities was the testimony of the Taxpayer's field supervisor. He testified that 2 of the 23 field employees worked exclusively on the water disposal system, 3 worked exclusively on the gathering pipelines, and 2 were assigned to the compressor stations. The remaining 16 "pumpers" worked at the compressor stations and the wells.

The pumpers worked on average 10 hour days, and spent the first hour of each day

checking the compressor stations. They then traveled to the various wells in the field, where they spent on average 10 minutes at each well. At the wells, the pumpers spent approximately 1 minute checking the pump jack, 2 minutes reading and recording the sales allocation meter, and the remaining time checking the gathering pipes and valves. The field supervisor also testified that the pumpers spent a significant but unspecified amount of their time traveling between well sites.

The Department argues that it is not obligated to rely on the field supervisor's verbal assertions in lieu of records. It claims that the Taxpayer could have maintained either employee time sheets or written job descriptions identifying the time spent on the various field activities.

The field employees certainly could have kept daily time sheets, but requiring such meticulous minute-by-minute recordkeeping would be impractical and unreasonable. The Department also had never requested or required the Taxpayer to maintain such records in prior audits. The Taxpayer also could have provided written job descriptions, but again, the Taxpayer was not on notice that such records were necessary because the Department had previously estimated deductible field labor without requiring or requesting such records. In any case, written job descriptions would have included the same information provided through the credible testimony of the field supervisor. Arguably, the supervisor's testimony is better evidence because he was subject to cross-examination by the Department. While the Department argues that some of the field labor was not deductible, it failed to present evidence disputing the supervisor's testimony concerning the time spent on those activities. As the best information available, the supervisor's testimony must be used to estimate

deductible field labor. “Value is a question of fact, and value may be shown by expert testimony. . . .” *Phillips*, 638 So.2d at 689.

The Taxpayer concedes, at least for purposes of this appeal, that the 2 employees assigned to the water disposal system, or 8.696 percent of the field work force, cannot be deducted. The Department concedes that the 2 employees (another 8.696 percent) assigned to the compressor stations can be deducted. The dispute concerns the 3 employees assigned to the gathering pipelines, and also how the 16 pumpers should be allocated between deductible and nondeductible labor.

The Department argues that the 3 pipeline employees cannot be deducted because the U.S. Department of Transportation requires that the pipelines must be inspected for safety and environmental reasons. I disagree.

Reg. 810-8-6-.01(2)(a) allows a deduction for all “gathering” and “transportation” costs. The Taxpayer’s pipeline gathering system serves a required and necessary post-production function in gathering and transporting the Taxpayer’s gas. Any labor costs incurred in inspecting and maintaining the gathering system are allowed processing costs. It is irrelevant that pipeline inspection and maintenance is required by the federal government for environmental and safety reasons. The Taxpayer must comply with those rules. Consequently, the cost of compliance is a necessary cost in processing the gas. The cost of those 3 pipeline employees, representing 13.043 percent of the field labor, can be deducted.

The remaining 16 pumpers represent 69.565 percent of the field employees. The

field supervisor testified that the pumpers spent a significant but unspecified amount of time traveling every day. Given the short time spent at each well, and the large area covered by the field, it is reasonable to allocate one-half of the pumpers' time, or 34.783 percent, to travel. Further, because they performed both deductible and nondeductible functions at the wells, and would have traveled the same distance to perform either functions, the travel should also be allocated one-half deductible and one-half nondeductible, or 17.391 percent each.

The remaining 34.783 percent attributable to the pumpers represents the 5 hours (10 hour days less 5 hours travel) they spent each day at the compressor stations and well sites. The 1 hour at the compressor stations, or 6.957 percent, is deductible.

Of the remaining 27.826 percent representing the pumpers' time at the wells, the 1 minute spent checking the pump jacks is not deductible. That 1 minute represents 10 percent of the 10 minutes spent at each well, which equates to 10 percent of the remaining 27.826 percent, or 2.783 percent.

The 2 minutes spent reading and recording the meter at each well is questionable. The better argument is that reading the meters was not processing-related, and thus nondeductible. Those 2 minutes represent 5.565 percent of the remaining time. The time spent at each well checking the pipes, valves, etc., or 19.477 percent, was post-production, and thus deductible.

In summary, deductible field labor includes the 2 compressor station employees (8.696 percent), the 3 pipeline employees (13.043 percent), one-half of the pumpers' travel (17.391 percent), the 1 hour spent by the pumpers at the compressor stations (6.957

percent), and the time the pumpers spent checking the pipes, valves, etc. at the wells (19.477 percent). The deductible field labor was 65.564 percent of total field labor.[2]

The above calculations are admittedly based solely on the testimony of the field supervisor. But as indicated, his testimony was credible, and is the best evidence available. There is no evidence contradicting his testimony. If anything, the 65.564 percent allowed is an underestimate because the pumpers' travel time could be allocated by the percentage of their deductible versus nondeductible activities. In that case, approximately 85 percent of their travel time would be deductible, instead of the 50 percent allowed. Also, some part of the well meter reading and recording may be deductible. See, Taxpayer's Post-Hearing Brief, footnote 11, at 9.

This is a difficult issue because the dual functions performed by the field employees necessarily requires that deductible field labor must be estimated. In future audits, the Department may request a written description of the Taxpayer's field employees' activities, with a breakdown of the time spent on each activity. But such a description would still involve estimates by the Taxpayer, the same as the field supervisor's testimony relied on in this case. Requiring all of the field employees to maintain meticulous time sheets on a continuous basis would be unreasonable, although some of the field employees could reasonably maintain detailed time sheets over a sample period. I suspect, however, that if the Taxpayer provides the Department with detailed field employee time sheets in a future audit, the allowable field labor reflected on those sheets will be greater than the percentage

[2] The nondeductible percentages total 34.435. The combined deductible and nondeductible labor totals only 99.999 percent due to rounding.

allowed by this Order.

(2) Overhead.

The workback method allows a deduction for indirect administrative and other overhead costs. Like the field labor, overhead costs relate to both deductible and nondeductible activities. Consequently, not all overhead costs can be deducted. Department Reg. 810-8-6-.01(6)(b)7. attempts to identify deductible processing-related overhead, as follows:

> 7. ADMINISTRATIVE AND OVERHEAD COSTS. Administrative and overhead costs related to the supervision of facility operations, expense accounting, secretarial expense and the expense of marketing a product, shall be limited to ten percent of allowed depreciation, direct labor, contract services, materials, supplies, equipment rentals, fuel and power costs.

Before Reg. 810-8-6-.01 was promulgated in 1997, the Department and the Taxpayer had agreed that the Taxpayer's deductible overhead would be 10 percent of its total overhead costs. The Taxpayer thus programmed its computer to calculate total monthly overhead in one column of a print-out, and the allowable 10 percent of total overhead in another column. It then deducted the agreed 10 percent amount.

After Reg. 810-8-6-.01 was promulgated, the Department instructed the Taxpayer to follow the regulation. The Taxpayer complied. Unfortunately, to save money, the Taxpayer did not change its computer program. Consequently, the Taxpayer continued to print out a document showing total overhead in one column and 10 percent of total overhead in another column. The Taxpayer then hand calculated the 10 percent maximum specified by the regulation, which in each month of the audit period was considerably less than total

overhead. The Taxpayer thus deducted the 10 percent maximum in each month.[3]

On audit, the Department rejected the 10 percent maximum claimed by the Taxpayer, and instead allowed the lower 10 percent of total overhead amounts shown on the Taxpayer's monthly computer printouts. The Department contends that those amounts constituted deductible overhead as reflected on the Taxpayer's books and records. I disagree.

The 10 percent of total overhead shown on the Taxpayer's monthly computer print-out was not the Taxpayer's actual processing-related overhead. It was only an arbitrary amount agreed to by the parties as an estimate of deductible overhead before Reg. 810-8-6-.01 was promulgated. The fact that the Taxpayer continued to generate the number after Reg. 810-8-6-.01 was promulgated is irrelevant.

Reg. 810-8-6-.01(6)(b)7. is poorly worded. It awkwardly attempts to identify deductible processing-related overhead by limiting total overhead to 10 percent of various other non-overhead costs.[4]

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[3] The Taxpayer claimed in its appeal to the Administrative Law Division that it actually under-computed the maximum 10 percent overhead amount allowed by the regulation because it omitted its cost of fuel. The Taxpayer claims that as a result, it overpaid tax by approximately $30,000 during the audit period, and is due a refund. That issue is addressed below.

[4] The 10 percent maximum established in Reg. 810-8-6-.01(6)(b)7. appears to be an arbitrary amount. There is no evidence that deductible overhead costs attributable to processing are generally equal to 10 percent of the various non-overhead costs listed in the regulation. I can only speculate that the 10 percent limit was a compromise between the various Department and oil and gas industry representatives that drafted the regulation.

The Department interprets the regulation as allowing a taxpayer to deduct the lesser of either actual processing-related overhead or the 10 percent maximum allowed by the regulation. The Department's analysis is flawed because it would require a taxpayer to first compute deductible overhead, and then claim the lesser of that amount or the 10 percent maximum in the regulation. But calculating deductible overhead is the end goal of the regulation. If a taxpayer could otherwise independently calculate deductible overhead, there would be no need for the regulation.

The Department asserts in its Post-Hearing Brief at 14, that "Torch wants to deduct 10 percent of all its overhead costs. . . ." That is wrong. The Taxpayer deducted 10 percent of total overhead costs before Reg. 810-8-6-.01 was promulgated. However, since the regulation, the Taxpayer has deducted the 10 percent maximum established by the regulation because that amount was less than total overhead. It is the Department, not the Taxpayer, that is incorrectly arguing that the Taxpayer must deduct the arbitrary 10 percent of total overhead amounts shown on the Taxpayer's computer printouts.

The only reasonable interpretation of Reg. 810-8-6-.01(6)(b)7. is that total overhead shall be allowed up to the 10 percent maximum set by the regulation. Admittedly, if total overhead is less than the 10 percent maximum in a given month, then arguably some production-related overhead may be allowed. But that is how the regulation is written. In any case, that never occurred during the period in issue. In each month of the audit period, total overhead greatly exceeded the 10 percent maximum allowed by the regulation.[5]

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[5] For example, deductible overhead per the 10 percent maximum set by the regulation equaled 12.90 percent of total overhead in November 1999; 13.56 percent in (continued)

Consequently, the Taxpayer correctly deducted the 10 percent maximum in each month.

(3) Fuel Gas.

The Taxpayer uses gas severed from the field, or fuel gas, to operate its compressors, dehydration units, and other processing-related equipment. The parties agree that fuel gas can be deducted under the workback method. Reg. 810-8-6-.01(6)(b)5.(iii) concerns the fuel gas deduction, and reads as follows:

> If the source of the fuel used in a facility is the hydrocarbons derived from the facility, the fuel is taxable at gross value as determined herein. A fuel cost deduction of $.68 per MCF or actual cost shall be allowable, up to said gross value, for the cost of producing the fuel.

The issue is whether the Taxpayer can include a return on investment in computing its actual cost of producing fuel gas. It is undisputed that return on investment is an allowed cost under the workback method. See, Reg. 810-8-6-.01(6)(b)2.[6] The Department had also allowed the Taxpayer to consider return on investment in determining its fuel gas deduction in prior audits. The Department now argues, however, that while return on investment is an allowed cost, it is not an actual cost of producing fuel gas, and thus cannot

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July 2000; 12.92 percent in December 2000; 10.35 percent in July 2001; and 10.03 percent in November 2001. See generally, Exhibit 13. In effect, by following the regulation, the Taxpayer was allowed only a slightly larger monthly overhead deduction than the uniform 10 percent of total overhead allowed before the regulation.

[6] In the only Alabama case that has addressed the issue, the Tuscaloosa County Circuit Court found in *Black Warrior Methane Corp. v. State of Alabama* that return on investment is an allowed cost under the workback method "according to case law," *Black Warrior Methane* at 5, but the Court failed to cite the case law relied on. I assume return on investment is an allowed cost because the facility owner incurs a "cost" equal to the time value of the money invested in the processing-related equipment and facilities. In any case, Reg. 810-8-6-.01(6)(b)2. clearly includes return on investment as an allowed cost under the workback method.

be allowed.

The above fuel gas regulation is based in part on the *Black Warrior Methane* case, which was decided in December 1993. The Court in that case found that the "actual cost of producing" fuel gas could be deducted under the workback method. It then determined that Black Warrior Methane's cost of producing the gas in issue was $.68 per mcf.

In drafting the workback regulation, the Department adopted the $.68 per mcf allowed in *Black Warrior Methane*. It also allowed in the alternative that the actual cost of producing fuel gas may be claimed, up to the gross value, i.e. wellhead value, of the fuel.

The Circuit Court in *Black Warrior Methane* did not explain how it determined that the actual cost of producing the fuel gas was $.68 per mcf. Alabama's appellate courts also have never addressed the issue, nor does Reg. 810-8-6-.01(6)(b)5. The parties also failed to explain how the actual cost of producing fuel gas should be computed, regardless of whether return on investment is or is not a component. Consequently, I must make some assumptions in deciding the issue.

I initially assumed that the fuel gas used by the Taxpayer to operate its processing equipment and facility was refined gas because raw gas at the wellhead must be refined before it can be used. In that case, the Taxpayer's actual cost of the fuel gas would be its gross value at the wellhead, plus what it cost the Taxpayer to process the gas into useable form. The parties seem to agree, however, that only the cost of producing the gas, i.e. bringing the gas to the wellhead, should be considered. Consequently, I must assume that

fuel gas is raw, unrefined product. [7]

The Department argues that while return on investment is an allowed cost, it is not an actual cost, and thus should not be considered in determining the actual cost of producing the fuel gas. The Department agrees, however, that depreciation is an actual cost that must be allowed in computing the fuel gas deduction. The Department's severance tax supervisor testified as follows – "Well, depreciation you're allowed to include (in computing the cost of fuel gas). But ROI – depreciation is a cost, yeah. ROI is not a cost." (T. at 292, 293.)

The Department's distinction between an allowed cost and an actual cost is unconvincing. If return on investment was not a real, actual cost, it would not be allowed. Return on investment is as much an actual cost as depreciation, which the Department concedes is an actual cost in producing the fuel gas.

The Department contends that allowing a return on investment in computing the cost of producing fuel gas would result in a double deduction. "The 'Workback Rule' already

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[7] As discussed, the only Alabama Court to address the fuel gas issue was the Tuscaloosa County Circuit Court in *Black Warrior Methane*. That Court held, at page 4, that allowed gathering costs included "the actual cost of producing the compressor (fuel) gas used in treating the gas." The Department subsequently incorporated the Court's "cost of producing" language in Reg. 810-8-6-.01(6)(b)5.(iii). The Taxpayer has not disputed that the fuel gas deduction should be the cost of producing the fuel gas, and not the cost of producing and refining the gas, which further confirms my assumption that fuel gas must be gas in its unrefined state. That assumption is, however, contradicted by the language of the regulation, which states that the fuel gas is "derived from the facility." The "facility" referred to is the processing facility, which suggests that the fuel gas is gas previously processed at the facility before it is used. Obviously, it would have been helpful if the parties had presented evidence establishing that fuel gas is either raw or refined product, and also evidence as to how the cost of fuel gas should be computed, regardless of the return on investment issue.

makes sufficient provision for allowing an ROI deduction to oil and gas producers, and it makes no sense to interpret the 'Workback Rule' as providing a double deduction for 'fuel gas.'" Department's Post-Hearing Brief at 17.

That argument is wrong for two reasons. First, the Department concedes that depreciation is an allowed deduction under the workback method, and also should be considered in computing the cost of producing fuel gas. Consequently, the Department allows a "double deduction" for depreciation, but not for return on investment. I see no reason for the Department's distinction.

Second, the Taxpayer is not being allowed a double deduction for either depreciation or return on investment. Only processing-related costs are allowed under the workback method. Consequently, the investment basis on which the general depreciation and return on investment deductions are computed is "the costs actually incurred by the taxpayer in acquiring or constructing a (processing) facility." See, Reg. 810-8-6-.01(6)(a)1.
Of the approximately $300 million invested by the Taxpayer in this case, approximately $60 million relates to the processing facilities and equipment. That amount, as depreciated, was the Taxpayer's investment basis on which the general return on investment and depreciation deductions were computed.

However, because the fuel gas deduction is production-related, the depreciation and return on investment costs considered in computing the cost of producing fuel gas is based on the Taxpayer's cost of its production-related equipment and facilities, or $240 million, as

depreciated.[8] Thus, while the general depreciation and return on investment deductions are based on the Taxpayer's cost of its processing-related equipment, the depreciation and return on investment allowed in computing the cost of producing the fuel gas is based on the Taxpayer's separate, production-related property. Because the deductions are computed on a different investment basis, there is no double deduction.

Return on investment should be allowed as an actual cost in computing the fuel gas deduction.

The Taxpayer's Refund Claim.

As discussed in footnote 3, *supra*, the Taxpayer claims it failed to include its cost of fuel gas when it computed the maximum 10 percent overhead amount allowed by Reg. 810-8-6-.01(6)(b)7. The Taxpayer estimates that as a result, it overpaid tax by approximately $30,000 during the audit period. The Taxpayer concedes that the overpayment should be reduced by the $8,081.46 it underpaid in January 2001 when it overstated its fuel gas costs in that month. It argues, however, that a net refund is due.

The Taxpayer's refund claim raises a statute of limitations issue. A petition for refund must be filed within 3 years from the due date of a return. Code of Ala. 1975, §40-2A-7(c)(2)a. There is no evidence the Taxpayer raised its refund claim before it appealed

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[8] Again, this assumes that the fuel gas deduction is based on the Taxpayer's cost of producing the gas only. If the fuel gas is, in fact, refined product, then the Taxpayer's cost of the gas would be its cost of producing the gas and also processing the gas into usable form. If that was the case, the Department's double deduction argument may be valid. The computation would also be further complicated because in determining the cost of processing the fuel gas, the cost of the fuel gas used to operate the processing facility and equipment would have to be considered.

to the Administrative Law Division on August 28, 2002. The appeal stated in part – "In fact, if all proper overhead deductions were taken into account (including the 10% fuel cost factor that was not previously added), a tax refund would be due." Taxpayer's Notice of Appeal at 4. The Taxpayer did not, however, state the amount of the claimed refund until the February 4 hearing, at which it offered testimony estimating that the refund due was approximately $30,000.

The Taxpayer's notice of appeal did not technically qualify as a "petition for refund" as defined at Code of Ala. 1975, §40-2A-3(14) because it did not identify the amount of tax overpaid. It did, however, put the Department on notice that the Taxpayer was claiming a refund for the subject period. In such cases, the notice will be accepted as a valid refund petition if it is later amended to correct the technical deficiencies.

> It is well settled that "a notice fairly advising the Commissioner of the nature of the taxpayer's claim, which the commissioner could reject because too general or because it does not comply with formal requirements of the statute and regulations, will nevertheless be treated as a claim where formal defects and lack of specificity have been remedied by amendment filed after the lapse of the statutory period." *United States v. Kales*, 314 U.S. 186, 194, 62 S.Ct. 214, 218, 86 L.Ed. 132 (1941). "There are no rigid guidelines except that an informal claim must have a written component and should 'adequately apprise the Internal Revenue Service that a refund is sought for certain years.'" *Arch Engineering Co., Inc. v. United States*, 783 F.2d 190, 192 (Fed.Cir. 1986). See *Barenfeld v. United States*, 442 F.2d 371, 375, 194 Ct.Cl. 903 (1971); *American Radiator & Standard Sanitary Corp. v. United States*, 318 F.2d 915, 920, 162 Ct.Cl. 106 (1963).
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> The focus is on the claim as a whole, not merely the written component. In addition to the writing and some form of request for a refund, the only essential is that there be made available sufficient information as to the tax and the year to enable the Internal Revenue Service to commence, if it wishes, an examination into the claim.

Mills v. U.S., 890 F.2d 1133, 1135 (1989).

Based on the above authority, the Taxpayer's notice of appeal filed on August 28, 2002 will be treated as a timely filed refund petition relating to the overhead issue for all periods within three years from that date, which includes August 1999 and subsequent months.[9] Any amounts overpaid before August 1999 cannot be refunded or allowed as a credit, even though the months of January 1999 through July 1999 are included in the assessment period. The timely appeal of a final assessment cannot reopen a refund period that is otherwise time-barred.

> The appeal of a final assessment does not stay the statute of limitations at §40-2A-7(c)(2)a. under which a taxpayer is required to claim a refund for the subject period. . . .
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> The above result also is not changed by Code of Ala. 1975, §40-2A-7(b)(5)d.1. That statute provides that on appeal, the Administrative Law Division may increase or decrease a final assessment to reflect the correct amount due. The statute does not authorize the Administrative Law Division to order a refund (or credit) that is otherwise barred by the statute of limitations at §40-2A-7(c)(2)a.

C&D Chemical Products, Inc. v. State of Alabama, Corp. 00-288 (Admin. Law Div. 2/9/01) at 12-13.

CONCLUSION

The workback method is simple in concept – wellhead value equals tailgate sales price less processing and other post-production costs. The problem comes in determining

[9] Monthly severance tax returns are due by the 20th of the next month. Code of Ala. 1975, §40-17-5. Consequently, the Taxpayer's August 1999 return filed in September 1999 was within the 3 year statute.

how the allowed costs should be computed. As discussed, other than the general findings of the Circuit Court in *Black Warrior Methane*, no Alabama court has addressed the technicalities of the workback method.

Reg. 810-8-6-.01 provides some broad parameters, but does not provide the specific guidelines needed. That is clearly illustrated by this case. The regulation addresses labor expenses generally, but does not mention field labor, which I assume is a large expense for all oil and gas operators. The awkward language of the overhead provision is discussed above. The fuel gas provision also does not explain how the actual cost of producing the gas should be computed. I understand the difficult job the Department has in computing taxable value under the workback method. It would be well-served to revise Reg. 810-8-6-.01 and specify exactly how the workback method deductions should be computed.

The Taxpayer is directed to amend its refund request by submitting, with supporting documentation, the amount of tax overpaid in August 1999 and subsequent months as a result of underreporting its monthly overhead deduction. The Taxpayer should submit the information by August 29, 2003.

The Department is directed to recompute the additional tax due based on the $8,081.46 that the Taxpayer concedes it underpaid in January 2001, and also by reducing the field labor deduction from the 70 percent claimed by the Taxpayer to the 65.564 percent allowed by this Order. That information should also be submitted by August 29, 2003.

The Administrative Law Division will reconcile the additional tax due and the

amounts overpaid, as appropriate. A Final Order will then be entered.

This Opinion and Preliminary Order is not an appealable Order. The Final Order, when entered, may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered July 31, 2003.