CLAY CALHOUN, SR. Post Office Drawer 850108 New Orleans, Louisiana 70185-0108,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. MISC. 89-115
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed State and Baldwin County oil and gas severance tax against Clay Calhoun, Sr. ("Taxpayer") for the period August 1985 through December 1987. The Taxpayer appealed to the Administrative Law Division on January 31, 1989. A hearing was conducted on May 18, 1995. Jim Sizemore and Algert Agricola represented the Taxpayer. Assistant Counsel John Breckenridge represented the Department.

This case involves the following issues:

(1) Should the assessments be dismissed because of the long delay between when the administrative appeal was filed in 1989 and when the hearing was conducted in 1995;

(2) If the assessments are not dismissed, the substantive issue involves how the taxable "value" of the subject gas should be computed under the "workback" method. Specifically, should the following expenses be allowed: (a) secondary flow meters, (b) salt water disposal costs, (c) depreciation, and (d) transportation costs.

The Taxpayer operated and was a fractional working interest owner in six gas wells in Baldwin County during the period in question. The Department audited the Taxpayer and computed the Taxpayer's severance tax liability pursuant to the "workback" method. As discussed below, "value" is computed under the "workback" method by taking the first arm's-length sales price of the refined product, and then subtracting actual treatment costs. The parties agree that the "workback" method is applicable in this case.

The Department entered preliminary assessments of State and Baldwin County severance tax on October 17, 1988. After an unsuccessful informal conference, the Taxpayer appealed to the Administrative Law Division in January 1989.

The Administrative Law Division notified the Legal Division of the Taxpayer's appeal on February 8, 1989. The notice directed the Legal Division to "forward to (the Administrative Law Division) a short statement of the relevant facts, the matters asserted, the Department's position, and the issues involved". As discussed later, there was no time frame within which the Department was required to respond.

Department procedures, then and now, require that a position statement (now referred to as an Answer) should be filed before a case can be set for hearing. The Administrative Law Division inquired with the Legal Division on several occasions over the next few years concerning the status of the case, and specifically when a position statement would be filed.

The Legal Division responded that the case involved the "workback" method, and that the parties had agreed to hold the case generally pending a final decision in State v. Phillips Petroleum, which had been filed in Montgomery County Circuit Court in March 1988. As discussed below, the Taxpayer denies that he acquiesced in continuing this case generally. Unfortunately, there is nothing in the administrative record showing that the Taxpayer either agreed or objected to a continuance.

Phillips Petroleum was decided by the Montgomery County Circuit Court on November 1, 1990. The decision was appealed, and the Court of Civil Appeals issued its decision on December 6, 1991 (State v. Phillips Petroleum Co., 638 So.2d 880 (Ala.Civ.App.1991) or "Phillips I"). The Supreme Court granted certiorari and issued its opinion on December 18, 1992, (State v. Phillips Petroleum Co., 638 So.2d 886 (Ala. 1992) or "Phillips II"). The Supreme Court affirmed in part and reversed in part and remanded the case to the lower courts. The Court of Civil Appeals issued its decision on remand on July 9, 1993 (State v. Phillips Petroleum Co., 638 So.2d 890 (Ala.Civ.App. 1993) or "Phillips III"). The Supreme Court again granted certiorari and issued another decision on February 18, 1994 (State v. Phillips Petroleum Co., 638 So.2d 893 (1994) or "Phillips IV"). The Supreme Court concluded in Phillips IV that the Department could use the "workback" method under certain circumstances.

Shortly after Phillips IV was decided, the Administrative Law Division, by Order dated February 24, 1994, set this case for hearing on April 14, 1994. The Department was also directed to file an Answer, which it did on February 28, 1994.

The Taxpayer's representative at that time, his son, requested a general continuance because of the Taxpayer's ill health. A general continuance was accordingly granted. The Administrative Law Division later inquired concerning the Taxpayer's health by letters dated June 22 and August 3, 1994. The Taxpayer thereafter obtained local Alabama counsel, who filed a Motion to Dismiss Assessments and a Motion for Judgment on the Pleadings on November 23, 1994. Both motions were denied on January 30, 1995. A hearing was finally conducted on May 18, 1995.

Issue (1). Should the assessments be dismissed because the appeal was not timely heard.

The first question is - did the delay in hearing the case violate any statute or Department regulation.

Prior to October 1992, the Administrative Law Division procedures were governed generally by the Alabama Administrative Procedures Act ("APA"), Code of Ala. 1975, §41-22-1 et seq., and specifically by various Department regulations. The APA does not include any specific time limit within which a contested case must be heard.

Department Reg. 810-1-3-.04(1) was in effect when the Taxpayer's appeal was filed and provided that after an appeal was filed, the Administrative Law Division was required to notify the

Legal Division, and "the Department shall thereafter file with the Administrative Law Division a position statement setting forth the issues involved in the case and the Department's position relating thereto". Subparagraph (2) of the regulation provided that "Upon filing of the Department's position statement, the Administrative Law Division will incorporate said statement in a formal notice of hearing . . . ". However, Reg. 810-1-3-.04(1) did not specify a time limit within which the Legal Division was required to file a position statement. Consequently, the Department's delay in filing a position statement did not technically violate any statute or Department regulation.

The Uniform Revenue Procedures Act ("URPA") was enacted effective October 1, 1992. That Act requires the Legal Division to file an Answer within 30 days after being notified of an appeal. Code of Ala. 1975, §40-2A-9(c). But as explained in the Preliminary Order Denying Taxpayer's Motion to Dismiss Appeal, URPA applies only to appeals that were filed after the effective date of the Act, October 1992. The appeal in this case was filed in January 1989. Consequently, the 30 day Answer period required by §40-2A-9(c) is inapplicable.

A circuit court does have inherent equitable power to dismiss a case for unexcused delay. Mims v. Citizens Bank of Prattville, 581 So.2d 824 (1991); State Insurance Department v. Howell, 614 So.2d 1053 (Ala.Civ.App. 1992). However, there is no statutory or other authority giving the Department's Administrative Law Judge ("ALJ") that same inherent equitable authority. The ALJ is authorized by §40-2A-9(b) to dismiss an appeal or grant relief to a taxpayer, but only if a party fails to comply with a Department regulation, a statute, or a preliminary order issued by the ALJ. As discussed above, that did not happen in this case.

The next question - was the Department's delay in filing an Answer so unreasonable as to violate the Taxpayer's constitutional right to due process.

To begin, I disagree with the Department's claim in its brief, at page 2, that the Taxpayer had the affirmative duty to go forward with the hearing. Both before and after the enactment of URPA in 1992, once a taxpayer appealed, the Department was required to file an Answer, and only then would a hearing be scheduled, see Reg. 810-1-3-.04(2). A taxpayer was not required to take any action until an Answer was filed and a hearing was scheduled. The form letter mailed to the Taxpayer by the Administrative Law Division after the Taxpayer's appeal was filed provided in part as follows:

> You will be informed of the time and place set for the hearing by written notice to be sent from this office. The notice will inform you of the position taken by the Department and the issues involved in the matter.
>
> This confirmation letter requires no response on your part at this time. Its purpose is to acknowledge receipt of your request for a formal hearing and inform you of the required procedure to be followed in conducting formal contested hearings. You are forthwith to receive the above mentioned notice (of hearing).

As discussed, a hearing was not scheduled because the Department did not file an Answer and instead informed the Administrative Law Division that the parties had agreed to hold the case pending a final decision in Phillips Petroleum. The Taxpayer disputes that there was any such agreement, and in hindsight it is clear that any such agreement should have been put in writing for the record.

But while the record does not show that the Taxpayer formally agreed to a continuance, the Taxpayer also did not object and never inquired concerning the status of the case. The Taxpayer was certainly aware of the appeal and could have inquired concerning the case at any time. The Taxpayer by his non-action in effect acquiesced in the general continuance. Consequently, under the circumstances, the delay was not so unreasonable as to constitute a denial of due process.

The Department also is not barred by the doctrine of laches from proceeding with the assessments. Laches applies if (1) there was a delay, (2) the delay was not excusable, and (3) the delay resulted in undue prejudice. Citibank, N.A. v. Citibank Group, Inc., 724 F.2d 1540 (1984).

There obviously was a delay in this case. However, the delay was understandable or at least excusable for the reasons stated above. Importantly, the delay also did not cause undue prejudice to the Taxpayer.

The Taxpayer claims that he was prejudiced because he is now ill, he lost some of his records, and some of his partners are no longer available. (Taxpayer's brief at page 5). However, this case involves a question of law as to what expenses should be allowed in computing the "workback" method. The Taxpayer's records are not relevant to that legal issue, nor is the Taxpayer's ill health or the absence of his former partners.

Issue (2). Did the Department properly compute the taxable "value" of the gas under the "workback" method.

Alabama's oil and gas severance tax is measured by the "gross value of said oil and gas at the point of production". Code of Ala. 1975, §40-20-2(a)(1). "Value" is defined at Code of Ala. 1975, §40-20-1(3), as follows:

> The sale price or market value at the mouth of the well. If the oil or gas is exchanged for something other than cash, if there is no sale at the time of severance or if the relation between the buyer and the seller is such that the consideration paid, if any, is not indicative of the true value or market price, then the department shall determine the value of the oil or gas subject to the tax hereinafter provided for, considering the sale price for cash of oil or gas of like quality.

Under certain limited circumstances, if there is no cash sale at the well-head, or if there are no like-kind sales by which comparable value can be determined, "value" can be computed using the "workback" method. See, Phillips IV. The parties agree that the "workback" method is proper in this case.

The Alabama Supreme Court has defined the "workback" method as follows:

> A method for calculating market value of oil or gas at the well-head . . . Under this method costs of transportation, processing and treatment are deducted from the ultimate proceeds of the sale of the oil or gas and any extracted or processed products to ascertain well-head value.

Phillips II, at page 888.

Value computed under the "workback" method must "result in an amount approximating market value". Phillips II, at page 889. Also, "when the Department resorts to the workback method, which is disfavored as a method of calculating value, the assessment can be attacked by showing that the calculations improperly included or excluded items in such a manner that the end result does not fairly indicate value". Phillips II, at pages 889, 890.

The Revenue Department does not have regulations concerning the "workback" method. Nor has either party cited any case law or other authority defining the specifics of the method or what expenses should be allowed in computing "value" under the "workback" method. Consequently, applying the broad definition set out in Phillips II, the following guideline will be followed. If the expense was necessarily incurred in the actual treatment (processing, marketing, or transportation) of the gas anywhere from the point of severance (well-head) to the first arm's-length sale, the expense should be allowed. If the expense, although a necessary or reasonable expense to the producer, was not incurred in directly treating or processing the gas, it cannot be allowed.

Secondary flow meters.

The Taxpayer installed secondary flow meters (1) to verify the accuracy of the primary meters installed by the purchaser, Amoco Production, Inc., and (2) to separately measure the amount of gas produced by each well. While necessary to the Taxpayer's operation, the secondary meters were not used in actually treating or processing the gas. Consequently, applying the above guideline, they cannot be allowed as an expense under the "workback" method.

Salt water disposal.

Salt water was commingled with the gas during production. At or immediately past the well-head, the salt water was separated from the gas by use of a separator. The Taxpayer was then required to dispose of the salt water for both practical and environmental reasons.

Clearly, removing salt water is necessary in processing the gas. Actual separation costs should accordingly be allowed. But the cost of subsequently disposing of the salt water after separation was not a necessary and direct processing cost. Although the Taxpayer was required by law to properly dispose of the salt water, the disposal costs were not incurred in actually processing or treating the gas, and thus cannot be allowed.

Depreciation.

The Department concedes that depreciation should be allowed in computing the "workback" method. (Dept. brief at page 12). The

Department first subtracted a ten percent salvage value, and then allowed the Taxpayer an equal monthly depreciation deduction over the life of the depreciable asset, the gathering system. The depreciable life was the total period that the system was used, including the months when no production occurred.

The Taxpayer first argues that the ten percent salvage value was arbitrary and should not have been used. I disagree.

Salvage value is "the amount that a taxpayer can reasonably expect to receive for the asset on resale at the end of its useful life". Carland, Inc. v. C.I.R., 909 F.2d 1101, at 1106 (1990). Salvage value is necessarily estimated, and the burden is on the taxpayer to establish a different salvage value than the one allowed by the taxing authority. Smith v. Commissioner, 800 F.2d 930 (9th Cir. 1986). In the absence of evidence to the contrary, the government's estimated salvage value must be accepted. Browning v. C.I.R., 890 F.2d 1084 (9th Cir. 1989).

The Taxpayer argues that the gathering system had no salvage value because it had no value after production ceased. However, no evidence was offered to that effect, or to otherwise prove that the ten percent salvage value was excessive. Consequently, the Department's use of a ten percent salvage value, being prima facie correct, is affirmed.

The Taxpayer next argues that depreciation should be allowed to offset production dollar for dollar. That is, if depreciation exceeded production in any month, the excess depreciation should be carried over and used to offset production in other months. Again, I disagree.

Depreciation is not tied to or incurred relating to any specific gas production. Rather, it relates to the depreciable asset itself, the gathering system in this case, which depreciates or loses value at a fixed rate over a fixed period of time regardless of whether it is used or not. Consequently, depreciation cannot be allowed dollar for dollar to offset production. The Department thus properly refused to allow depreciation to be carried over from one month to offset production in other months.

Transportation expense.

The Taxpayer had transportation expenses in some months but no production. The Taxpayer argues that, like depreciation, the excess transportation expenses should be carried over to other months to offset production dollar for dollar.

This issue of whether excess marketing costs in one month can be carried over to other months was previously rejected because severance tax returns are filed monthly, and there is no provision for a carryover of an expense to other months. See, Preliminary Order Denying Taxpayer's Motion for Judgment on the Pleadings, issued January 30, 1995. However, on review, I now believe that the Taxpayer's position on this point relating to the transportation expense (and any other direct processing expenses but not depreciation) is correct.

Unlike depreciation, transportation is a direct cost incurred in treating or processing the gas. That direct expense must be allowed in computing taxable value under the "workback" method. Consequently, notwithstanding that returns are due monthly, any allowable transportation expense relating to gas produced by the Taxpayer must be allowed, even if the expense was actually incurred or paid in a later month. Otherwise, the taxable value of the gas would be inflated.

In summary, the "workback" method involves determining "the aggregate sales price of the treated products and then subtracting the actual treatment costs . . .". Phillips IV, at page 894. The secondary flow meters and the salt water disposal costs cannot be allowed because they were not direct, actual treatment costs that added value to the gas.

Depreciation is an allowable expense, but can only be allowed in equal monthly increments. The asset (gathering system) loses value over time whether or not any gas is produced and carried through the system. Consequently, the monthly depreciation allowance cannot be carried over to offset production in other months.

On the other hand, transportation expense is a direct processing cost relating to oil or gas actually produced. Total transportation expense must be allowed to offset production, even if the expense is incurred in a subsequent month.

I must reiterate that the Department has no regulations or other guidelines defining how the "workback" method should be computed. Nor has either party presented any authority in that respect. Consequently, the above findings are based on the Supreme Court's broad holding in Phillips IV, at page 894, that only "actual treatment costs" should be considered.

The Taxpayer argues that an expense should be allowed if it "is one which would influence buyer and seller at a well-head sale" (Taxpayer's brief at page 8). If the Taxpayer is correct, then the secondary flow meters and the salt water disposal costs, and perhaps even depreciation dollar for dollar, should be allowed. A buyer would obviously consider those necessary expenses when buying gas at the well-head. But absent authority to support the Taxpayer's argument, only “actual treatment costs” can be allowed.

The Department is directed to recompute the Taxpayer's liability in accordance with the above findings. A Final Order will then be entered setting out the Taxpayer's adjusted liability.

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

Entered October 31, 1995.

BILL THOMPSON
Chief Administrative Law Judge