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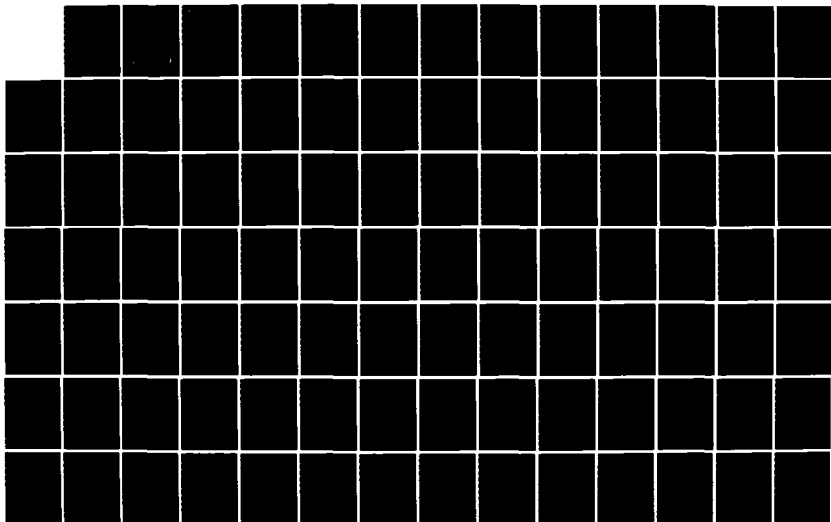
IRS' ADMINISTRATION OF THE CRUDE OIL WINDFALL PROFIT
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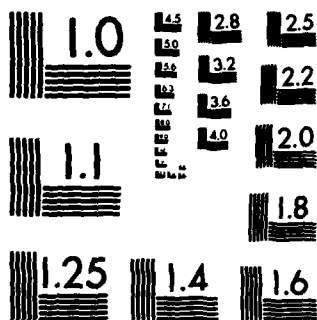
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BY THE COMPTROLLER GENERAL
Report To The Chairman, Subcommittee On
Commerce, Consumer And Monetary Affairs,
House Committee On Government Operations
OF THE UNITED STATES

IRS' Administration Of The Crude Oil
Windfall Profit Tax Act Of 1980

Anticipating that the removal of oil price controls would significantly increase the oil industry's profits, the Congress enacted the Crude Oil Windfall Profit Tax Act of 1980. Under the act, oil producers pay a tax on the difference between the free market price of a barrel of oil and its controlled selling price under Department of Energy regulations. Although IRS received no supplemental funding to administer the tax, it moved quickly to establish a compliance program. So that it can further strengthen this program, GAO recommends that IRS develop a more effective means for

- deciding which properties containing oil wells should be subject to IRS examination;
- ensuring that the windfall profit tax was in fact assessed on the initial sale of oil subsequently resold many times; and
- examining tax refund claims based on the very complex section of the law which is designed to assure that the tax is levied only on barrels of oil which, when sold, yield a profit to the seller.

The Congress, Treasury, and IRS have improved the administration of the windfall profit tax by defining key terms involved in calculating the tax. To further facilitate windfall profit tax administration, however, the Congress should consider streamlining procedures for issuing tax due notices and appealing IRS decisions to the courts. Treasury and IRS generally agreed with GAO's conclusions and recommendations.



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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

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The Honorable Doug Barnard
Chairman, Subcommittee on Commerce,
Consumer and Monetary Affairs
Committee on Government Operations
House of Representatives

Dear Mr. Chairman:

This report, in response to your Subcommittee's request, discusses the Internal Revenue Service's administration of the Crude Oil Windfall Profit Tax Act of 1980. The report points out that IRS has made progress in administering the windfall profit tax. Nonetheless, it also specifies various legislative and administrative actions which can be taken to facilitate windfall profit tax administration.

As arranged with your office, we are sending copies of this report to other congressional committees, individual members of the Congress, and other interested parties.

Sincerely yours,

Charles A. Bowsher

Comptroller General
of the United States

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COMPTROLLER GENERAL'S
REPORT TO THE CHAIRMAN,
SUBCOMMITTEE ON COMMERCE,
CONSUMER AND MONETARY
AFFAIRS, HOUSE COMMITTEE ON
GOVERNMENT OPERATIONS

IRS' ADMINISTRATION OF
THE CRUDE OIL WINDFALL
PROFIT TAX ACT OF 1980

D I G E S T

Anticipating that the removal of oil price controls would significantly increase the oil industry's profits, the Congress enacted the Crude Oil Windfall Profit Tax Act of 1980. The crude oil tax, perhaps the largest and most complex tax ever levied on a U.S. industry, was designed to tax the difference between the free market price of a barrel of oil and its controlled price under Department of Energy regulations.

The windfall profit tax law requires interaction among oil producers, operators, and withholding agents. Producers are the 1 million or so individuals and business entities who own an interest in oil-producing properties and are liable for the tax. Operators are the approximately 18,000 individuals or entities who actually manage the oil drilling and production process and provide most of the information necessary for calculating the tax. Withholding agents--particularly the 500 to 600 initial purchasers of oil--compute and withhold the windfall profit tax attributable to the sale. (See pp. 2 to 6.)

WHY THE REVIEW WAS MADE

Given the complexity of the tax and the billions of dollars in revenue involved, the Chairman, Subcommittee on Commerce, Consumer and Monetary Affairs, House Committee on Government Operations, asked GAO to assess IRS' administration of the crude oil windfall profit tax. Accordingly, GAO's objective was to assess whether and to what extent IRS had successfully set up a viable compliance program for the tax.

IRS' COMPLIANCE PROGRAM

Although enacted on April 2, 1980, the Crude Oil Windfall Profit Tax Act of 1980 was made retroactive to March 1, 1980. Accordingly, IRS needed to move quickly to establish a compliance program. In particular, IRS needed to set up examination and collection programs for the crude oil tax. And, although it received no supplemental staffing or funding to administer the complex windfall profit tax, IRS nevertheless moved quickly to establish these activities.

Examination Division activities

IRS' first priority in developing compliance activities was to begin examining the windfall profit tax-related books and records of oil producers, operators, and withholding agents. Through early "test" examinations, IRS gained experience which proved useful in refining training materials and developing examination guidelines. From seven test examinations initiated in September 1980, IRS' inventory of examinations in process grew to 7,075 by September 30, 1983.

IRS thus has made good progress toward establishing an examination program for the windfall profit tax. Even so, some issues remain unresolved. The Examination Division, for instance, has experienced difficulties in (1) deciding which properties containing oil wells should be subject to IRS examination; (2) ensuring that the windfall profit tax was in fact assessed on the initial sale of oil subsequently resold many times; and (3) examining tax refund claims based on the very complex section of the law which is designed to assure that the tax is levied only on barrels of oil which, when sold, yield a profit to the seller. (See pp. 14 to 34.)

Collection Division activities

IRS' Collection Division is responsible for identifying delinquent taxpayers and collecting delinquent taxes. Like the Examination Division, IRS' Collection Division established a compliance program for the windfall profit tax. But the Division's ability to structure

a long-term, effective compliance program for identifying delinquent windfall profit taxpayers will depend largely on the availability, completeness, and accuracy of annual information returns.

The annual information return, Form 6248, serves as IRS' major windfall profit tax compliance document. However, IRS has experienced some problems with nonfiling of information returns as well as with filed returns which are incomplete or inaccurate.

Given the importance of the annual information return to IRS' windfall profit tax compliance program, a penalty for failure to file Form 6248 clearly was needed. The Congress enacted that penalty as part of the Technical Corrections Act of 1982. Furthermore, another law, the Tax Equity and Fiscal Responsibility Act of 1982, increased the penalty for failure to supply social security or other taxpayer identification numbers on information returns.

Together, these penalties should help IRS improve compliance. IRS also can promote better compliance by identifying and correcting incomplete and inaccurate information returns during examinations of withholding agents. (See pp. 35 to 42.)

LEGISLATIVE CHANGES ARE NEEDED TO THE INTERNAL REVENUE CODE

There are two legislative changes through which windfall profit tax administration could be further facilitated.

Notices of tax due

The Congress should expand IRS' authority to issue notices of additional tax due as a result of examinations of oil properties. IRS presently is limited by law to the issuance of a single notice of tax due per taxpayer each year. Thus, issuance of notices of tax due with respect to a single oil-producing property in any given year means that IRS would be prohibited from issuing the subject taxpayers any further notices that year.

Yet many producer-taxpayers invest in multiple oil properties managed by different parties. IRS thus has found it necessary to refrain from issuing notices until it has consolidated the results of numerous examinations of oil properties. If IRS were able to issue notices of tax due after each examination, both the government and taxpayers could benefit. The government would benefit from faster collection of additional taxes due; taxpayers would benefit from reduced interest charges on any additional tax they must pay. (See pp. 75 to 78.)

Court appeals

The Congress also should modify the law governing court appeals of IRS decisions. Under present law, each individual producer in an oil property has the right to appeal any IRS decision to the courts. Where individual circumstances can vary, this appeal right is both necessary and appropriate. But there are certain oil property-related issues which do not vary from one individual producer to another.

For example, the kind of oil obtained from a particular well necessarily is the same for all producers owning an interest in that well. Therefore, it is inefficient and duplicative to allow each individual producer to appeal that issue separately to the courts. Accordingly, there is a need for legislation to prevent duplicative court appeals. (See pp. 78 to 83.)

RECOMMENDATIONS TO THE SECRETARY OF THE TREASURY AND THE COMMISSIONER OF INTERNAL REVENUE

GAO makes a series of recommendations, some to the Secretary and some to the Commissioner. GAO believes that implementation of these recommendations should both strengthen IRS' windfall profit tax compliance activities and result in more efficient administrative procedures. (See pp. 13, 48, 49, 67, 87, and 88.)

RECOMMENDATIONS TO THE CONGRESS

To further facilitate windfall profit tax administration, GAO recommends that the Congress revise the Internal Revenue Code as it relates to (1) IRS issuance of notices of tax due and (2) court appeals procedures. Concerning notices of tax due, GAO recommends that the Congress authorize IRS to issue them on a property-by-property basis. Otherwise, significant revenue collection delays necessarily will be encountered as IRS seeks to consolidate examination results for producers' various properties. (See p. 88.)

Concerning appeals, there is a need to assure that the same examination issues do not lead to duplicative court cases. Taxpayers, of course, need to be able to appeal IRS examination determinations. But GAO recommends that the Congress establish a consolidated appeals process for issues which affect all producers in any given oil property in the same manner. This would help prevent the Tax Court's already heavy case backlog from further increasing. (See p. 88.)

AGENCY COMMENTS

With few exceptions, the Treasury Department and IRS generally agreed with GAO's findings, conclusions, and recommendations. Treasury and IRS specified that various actions would be taken to strengthen windfall profit tax enforcement activities and to facilitate administrative procedures. They also agreed with GAO's legislative recommendations to the Congress regarding notices of tax due and court appeals. (See pp. 13, 49, 50, 67, 88, and app. I.)

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CHAPTER 1

INTRODUCTION

For more than 10 years, mandatory federal controls governed the price of most domestically produced crude oil. Oil price controls were first instituted in August 1971 under President Nixon's general wage-price freeze. Subsequently, the controls were extended and strengthened through various laws and administrative decisions. On April 5, 1979, however, President Carter announced his intention to lift price controls on domestic crude oil. The announced decontrol program permitted domestic crude oil to sell at gradually increasing prices until full decontrol on September 30, 1981.¹ Further information concerning the history of oil price controls is included in appendix II.

Recognizing that removal of price controls would significantly increase oil industry profits, the Congress passed the Crude Oil Windfall Profit Tax Act of 1980 (P.L. 96-223, Apr. 2, 1980). The windfall profit tax is the largest and perhaps most complex tax ever levied on a U.S. industry. When enacted, it was estimated that the tax would yield over \$227 billion in about 10 years.

THE SUPREME COURT HAS UPHELD THE CONSTITUTIONALITY OF THE WINDFALL PROFIT TAX

About 6 months after the Crude Oil Windfall Profit Tax Act was passed, its constitutionality was questioned in a suit filed October 14, 1980, in the Federal district court for the district of Wyoming. The plaintiffs in the case--more than 30 groups representing thousands of producers and royalty owners--alleged that the Crude Oil Windfall Profit Tax Act was unconstitutional because the tax was not uniformly levied from a geographic standpoint. Specifically, the suit alleged that, because certain crude oil produced in Alaska is exempt from the windfall profit tax, the act violates the uniformity provision (Article 1, Section 8, Clause 1) of the Constitution. In this regard, the windfall profit tax is an excise tax, and the U.S. Constitution requires that an excise tax be geographically uniform.

On November 4, 1982, the federal district court ruled that the Alaska exemption violated the constitutional requirement of uniformity for excise taxes. The court further concluded that the exemption for Alaskan oil could not be severed and that, consequently, the entire crude oil tax was void. However,

¹President Reagan accelerated this timetable with his January 1981 decision to immediately decontrol oil prices.

the district court's judgment permitted the federal government to continue collecting the windfall profit tax until a higher court reviewed the decision.

On June 6, 1983, in a unanimous ruling, the Supreme Court upheld the constitutionality of the windfall profit tax. The Court's decision stated, in part, that "Where, as here, Congress has exercised its considered judgment with respect to an enormously complex problem, we are reluctant to disturb its determination."²

THE WINDFALL PROFIT TAX ACT
REQUIRES INTERACTION AMONG PRODUCERS,
OPERATORS, AND WITHHOLDING AGENTS

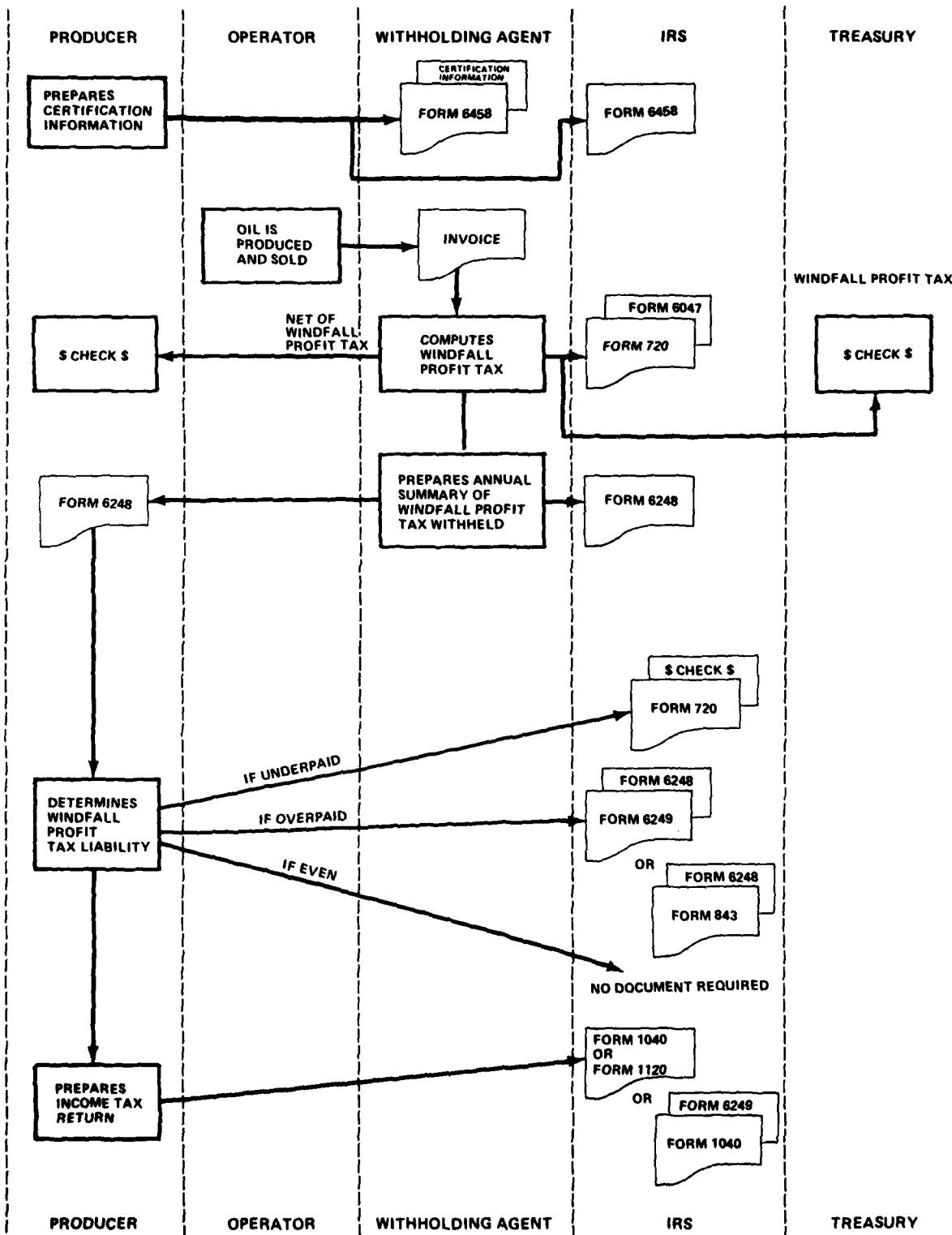
The windfall profit tax is unique in the way it is structured and imposed. The tax is very complex in design and operation and requires interaction among producers, operators, and withholding agents. Producers are individuals and business entities who own an interest in an oil-producing property. Operators are the individuals who actually manage the oil production process. Withholding agents--generally the first purchasers of oil--compute and withhold the windfall profit tax attributable to the sale. The responsibilities of the various parties under the act are described below and discussed in further detail in appendix III.

Producers, operators, and withholding agents interact with IRS and each other under the windfall profit tax system, as shown in the following chart.

²United States v. Ptasynski, 103 S. Ct. 2239 (1983).

Figure 1

THE WINDFALL PROFIT TAX PROCESS



The applicable windfall profit tax rate is determined through a matrix of oil tiers and producers. There are three different oil tiers, graduated generally on the basis of (1) the "windfall" element and (2) an incentive aspect to encourage new production. Tier 1 refers to oil from a property which produced oil in 1978 and generally is referred to as old oil. In tier 2, the main category is stripper oil, which is defined as crude oil from a property whose average daily production per well does not exceed 10 barrels per day. Tier 3 oil includes oil from a property which had no production in one specific year--1978. This oil is classified as newly discovered oil.

The other part of the tax rate matrix is the type of producer. There are four kinds of producers--integrated oil companies, independent producers, royalty owners, and tax-exempt parties. Integrated oil companies engage in all phases of the oil industry--exploration, production, transportation, refining, and retailing. Independent producers generally are smaller than integrated companies and are active in exploratory drilling. Royalty owners are any owners of economic interests (in oil properties) that are defined as royalties for income tax purposes. Tax-exempt parties include, for example, qualified charitable organizations and certain Indian tribes.

Integrated oil companies and royalty owners are subject to higher windfall profit tax rates than are independent producers for tier 1 and tier 2 oil. Table 8 in appendix III shows the applicable windfall profit tax rates by oil tiers and producer status and also identifies the various types of exemptions.

As established by the 1980 Act, the windfall profit tax rate in effect for calendar years 1980 and 1981 ranged from 30 percent of the windfall profit for newly discovered oil to 70 percent of the windfall profit for old oil. The windfall profit tax rate applicable to newly discovered oil is 27.5 percent for 1982, 25 percent for 1983, and 22.5 percent for 1984. Pursuant to the Economic Recovery Tax Act of 1981 (P.L. 97-34, Aug. 13, 1981), the tax rate for this oil category is being lowered annually from the 30 percent rate applicable in 1980 and 1981 to a rate of 15 percent in 1986 and later years. The tax rate applicable to old oil has remained unchanged.

The windfall profit tax process begins with information supplied by operators and producers. Operators must certify to the withholding agent the tier of oil being produced and related information such as the amount of oil being sold. There is no standard form for certifying oil tier and related information. Producers use certification and election Form 6458 to certify their status to the withholding agent and to IRS. Hundreds of producers can have fractional interests in a single oil-producing property. If oil tier and producer status information is not made available, the withholding agent usually will apply the highest possible windfall profit tax rate.

When oil is actually produced and sold, the operator gives the withholding agent an invoice. The withholding agent must compute and withhold the windfall profit tax on the basis of the certified information provided by the operator and by producers. Many variations of the calculation are possible depending on such considerations as the tier of the oil, its removal price, the kind of producer involved, and whether the state's severance tax qualifies as a deduction for windfall profit tax purposes.

Having computed the tax, the withholding agent pays the producers³ for the oil but withholds the tax from those payments. The withholding agent then deposits the tax dollars with the Treasury. Integrated oil companies are required to deposit withheld taxes twice a month; independent producers need make deposits only every 45 days. Regardless of deposit requirements, withholding agents must account for amounts paid into the Treasury on a quarterly basis via excise tax return Form 720, together with windfall profit tax accounting Form 6047.

Annually, the withholding agent prepares an information return, Form 6248, for each producer, summarizing windfall profit tax withholdings. The withholding agent sends copies of the Form 6248 to producers and to IRS.

The tax withheld, as shown on the Form 6248 information return, may exceed the actual liability because the law includes a provision to ensure that the tax does not render oil production unprofitable. That provision is referred to as the net income limitation. Basically, the taxable windfall profit on a barrel of crude oil is limited, by law, to 90 percent of the net income attributable to that barrel. The net income per barrel is defined as the taxable income from the oil property divided by the number of barrels of taxable crude oil produced by the property during the taxable year. Due to the net income limitation, a year-end refund may be due a producer. Table 9 in appendix III gives an example computation.

Producers are advised to compute their windfall profit tax liability before filing an annual income tax return. This is because the windfall profit tax is deductible on both individual and corporate income tax returns and thus reduces the producer's income tax liability. Also, producers who are royalty owners generally are entitled to a limited exemption from the windfall profit tax for specified amounts of oil production. The exemption is two barrels a day for 1982, 1983, and 1984, and three barrels a day for years after 1984.

³Operators frequently serve as conduits for first purchaser payments to producers.

The windfall profit tax is by definition an excise tax. However, IRS has recognized that traditional excise tax procedures will not be adequate for administering the windfall profit tax because of the unique way in which the tax is imposed upon the petroleum industry. For example, most excise taxes are computed on the basis of a flat percentage or monetary rate, which is applied to verifiable production or sales units. The windfall profit tax rate, on the other hand, although applicable to verifiable production units, is not flat, but is computed on a property-by-property basis and involves numerous variables. Thus, complexity rules out use of traditional excise tax return compliance programs.

Moreover, there are several reasons why traditional income tax return compliance procedures cannot be applied wholesale to windfall profit tax administration. For example, the parties actually liable for the tax--producers--often are not required to file windfall profit tax returns. Rather, operators maintain the records needed to determine a producer's tax liability and generally provide the information to withholding agents. In turn, the withholding agents file tax returns with respect to producers' tax liability.

The windfall profit tax is further unusual in that it is a temporary severance tax. That is, the tax is to begin to phase out 1 month after \$227.3 billion has been raised or in January 1988, whichever is later. However, if this amount has not been raised by January 1, 1991, the tax will begin to phase out at that time. In either case, the phaseout is to occur over a 33-month period. In chapter 2 of this report, we discuss the current status of windfall profit tax revenues in relation to the original congressional estimates.

In the remainder of the report we present and analyze tax administration issues pertaining to the windfall profit tax. Chapter 3 deals with IRS' efforts to develop and implement various windfall profit tax compliance programs. Chapter 4 discusses some basic definitional issues related to the oil production process which have affected IRS' efforts to administer the windfall profit tax. Chapter 5 discusses the need to streamline certain procedures with a view toward facilitating windfall profit tax administration.

OBJECTIVE, SCOPE, AND METHODOLOGY

Our objective was to assess IRS' efforts in administering the Crude Oil Windfall Profit Tax Act of 1980. Since January 1981, we have been analyzing the Service's activities in the windfall program. On April 13, 1981, we testified before the Subcommittee on Commerce, Consumer and Monetary Affairs, House Committee on Government Operations, and discussed the status of

windfall profit tax revenues and the status of IRS' compliance program. At that time, we reported that it was too early to determine the status of windfall profit tax revenues. We also pointed out that, despite a lack of supplemental funding for windfall profit tax administration, IRS had moved quickly to promote voluntary compliance with the new law. However, we offered two cautions. First, while the Service had initiated an examination program, the initial examinations were directed at first purchasers. Examinations directed at operators, the entities which must certify the key tax determination elements such as oil tier, had not yet been initiated. Second, at the time of the April 1981 hearings, IRS had not developed an overall compliance program which integrated all affected Service activities, such as the Collection Division and the Criminal Investigation Division.

This report, prepared at the request of the Chairman, Subcommittee on Commerce, Consumer, and Monetary Affairs, generally updates the status of these revenue and compliance issues through April 1983. In gathering and analyzing tax revenue data, we interviewed appropriate Treasury Department and IRS national office officials. In reviewing IRS' compliance activities, we contacted Service officials at the national, regional, and district office levels and participated in the Service's windfall profit tax training program.

Most of our field work was done in IRS' Southwest region, the lead and most active IRS region in the windfall profit tax program. In fiscal year 1981, for instance, this region accounted for 89 percent of the Service's total examination time spent in the windfall program. During our review, we visited 7 of the 10 district offices in the Southwest region and discussed a wide variety of windfall profit tax compliance issues with district office managers, revenue agents, engineers, revenue officers, and special agents. We also reviewed selected case files pertaining to first purchaser and operator examinations being conducted within the districts, as well as closed collection and criminal investigation cases. Further, we visited the Austin Service Center, which was designated by IRS to manage a planned, stand-alone, computerized information system for windfall profit tax activities.

We also made similar inquiries in IRS' Western region, the second most active IRS region in the windfall program. There, our review efforts were centered largely in the Los Angeles district office, where the majority of the region's windfall profit tax activity takes place. We also visited the Fresno Service Center.

Finally, we met with industry representatives and reviewed industry comments on windfall profit tax regulations proposed by IRS. We considered industry views in formulating our recommendations. Our review work was performed in accordance with generally accepted government auditing standards.

CHAPTER 2

NET WINDFALL PROFIT TAX

RECEIPTS MAY NOT TOTAL

\$227.3 BILLION

When enacted in April 1980, the Crude Oil Windfall Profit Tax Act was estimated to raise \$227.3 billion in net revenues over a 10-year period. However, due to lower than expected oil price and production levels, as well as some recent legislative changes, it now appears that the tax may fall far short of this amount. In fact, in February 1984, the Treasury Department estimated that cumulative revenues through the end of calendar year 1986 would total \$69.1 billion less than initially estimated.

Nevertheless, the windfall profit tax has generated and probably will continue to generate substantial revenues. For example, over \$58 billion in gross revenues were collected during the period March 1, 1980, through June 30, 1983.¹ Gross revenues represent the total amounts of windfall profit tax collected before considering the fact that the windfall profit tax is deductible for income tax purposes. Because the Congress intended that revenues derived from the windfall profit tax be appropriated for three specific purposes--income tax reductions, low-income assistance, and energy and transportation programs--proper accounting is important. In this regard, the act requires that the Secretary of the Treasury record net windfall profit tax revenues into a separate Treasury account and establish subaccounts for the three specified purposes. Treasury, however, is recording gross, rather than net, revenues in the account. The Secretary of the Treasury needs to correct this problem.

THROUGH 1986, TREASURY PREDICTS THAT WINDFALL PROFIT TAX REVENUES WILL BE \$69.1 BILLION LESS THAN INITIALLY ESTIMATED

In February 1984, the Treasury Department predicted that net windfall profit tax revenues would total about \$57.4 billion through calendar year 1986. In contrast, the conference report accompanying the April 1980 Act estimated that net revenues through 1986 would total \$126.5 billion. The following table compares the conference report's net revenue estimates to the recent Treasury Department estimates.

¹Although enacted on April 2, 1980, the windfall profit tax was made retroactive to March 1, 1980.

Table 1

Estimated Net Windfall Profit Tax Revenues
(in billions)

<u>Calendar year</u>	<u>Conference report (April 1980)</u>	<u>Treasury Department (February 1984)</u>	<u>Excess or (shortfall)</u>
1980	\$ 6.3	\$ 4.7	(\$1.6)
1981	14.7	14.8	0.1
1982	18.9	12.6	(6.3)
1983	20.1	11.4	(8.7)
1984	21.3	6.4	(14.9)
1985	22.3	4.1	(18.2)
1986	<u>22.9</u>	<u>3.4</u>	<u>(19.5)</u>
Total	<u>\$126.5</u>	<u>\$57.4</u>	<u>(\$69.1)</u>

Thus, Treasury's most recent estimate indicates that \$69.1 billion less revenue is anticipated from March 1980 through December 1986 than the amount estimated in the conference report. About \$13 billion of the anticipated \$69.1 billion shortfall is attributable to certain provisions in the Omnibus Reconciliation Act of 1980 and the Economic Recovery Tax Act of 1981, according to the staff of the Joint Committee on Taxation. The former act provided oil royalty owners a \$1,000 credit against the windfall profit tax, resulting in an estimated \$200 million in total foregone revenues. The latter act provided for certain exemptions for royalty owners and stripper oil production and for gradual reductions in the windfall profit tax rate applicable to newly discovered oil. These provisions will result in an estimated \$12.8 billion in foregone windfall profit tax revenues through 1986.

According to Treasury Department officials, most of this \$69.1 billion--as much as \$56.1 billion--is attributable to lower than expected oil price and production levels. In this regard, the original revenue estimate, contained in the conference report on the act, assumed that the price of a barrel of oil would increase at the rate of inflation plus 2 percent per year. Oil prices, however, did not rise as expected and, in fact, began decreasing in 1982. In June 1982, Treasury projected that oil prices in 1986 will be about 20 percent lower than those used in developing the conference report estimate.

Treasury also estimated that oil production would decline from 8.2 billion barrels in 1981 to 7.5 billion barrels in 1985.

Thus, the Treasury Department anticipates substantially less windfall profit tax revenue through 1986 than the amount estimated in the conference report. Still, the tax has already generated and will continue to generate large sums of money--a total of \$57.4 billion through 1986 according to the Treasury Department. Given the significance of this amount and given that the Congress intended that these revenues be appropriated for three specific programs, accurate accounting is important. However, as discussed below, Treasury is not currently accounting properly for net windfall profit tax revenues.

TREASURY NEEDS TO PROPERLY
ACCOUNT FOR NET WINDFALL
PROFIT TAX REVENUES

The act requires that the Secretary of the Treasury record net revenues into a separate "Windfall Profit Tax Account" at the Treasury. Treasury, however, is recording gross revenues into that account. Because proper windfall profit tax accounting is important for several reasons, the Secretary needs to correct this problem.

According to the act, net windfall profit tax revenues must be recorded into a separate Treasury account for accounting purposes. Further, the net windfall profit tax revenues in the separate Treasury account are to be allocated, as follows, by specific percentages into three subaccounts:

- income tax reductions (60 percent),
- low-income assistance (25 percent),² and
- energy and transportation programs (15 percent).

Treasury, however, has not complied with the act's specific requirements for windfall profit tax accounting. Specifically, Treasury has been recording gross, rather than net, revenues into the Windfall Profit Tax Account. Gross revenues represent the total amounts of windfall profit tax collected before considering the fact that the windfall profit tax is deductible for income tax purposes. Because Treasury is recording gross,

²The amounts allocated for this purpose were to be further suballocated as follows--50 percent to a program to assist Aid to Families With Dependent Children and Supplemental Security Income recipients under the Social Security Act and 50 percent to a program of emergency energy assistance.

rather than net, revenues into the Windfall Profit Tax Account, the Congress lacks data on the actual amount that could be appropriated for the three purposes set forth in the act.

According to Treasury Department representatives, the required recording and allocations of net windfall profit tax revenues have not been made primarily because net revenues need to be determined through use of estimates. That is, in order to calculate net revenues, Treasury would need to estimate the extent to which producers' windfall profit tax payments reduce their income tax liabilities. This is because the windfall profit tax is deductible for income tax purposes. We can understand the difficulties associated with developing estimates of net revenues. On the other hand, the difficulties associated with the task should not prevent Treasury from seeking to comply with the law, even if to do so would require the use of estimates.

The fact that Treasury has been allocating gross revenues into the Windfall Profit Tax Account may, however, have had no practical effect through fiscal year 1982. This is because the act's provisions concerning the three specific uses for windfall profit tax revenues do not become operative unless the Congress specifically appropriates windfall profit tax revenues. For fiscal years 1981 through 1983, the Congress chose not to appropriate those funds. As a result, the revenues reverted to the general fund. In a March 26, 1982, letter to the Speaker of the House of Representatives, the Secretary of the Treasury reported that

"The estimated net revenues from the [windfall profit] tax for [fiscal year] 1981 totaled \$13.8 billion . . .

"Under the Act, the President is required to propose the disposition of the net revenues among programs to aid low-income households, income tax reductions, and energy and transportation programs. Congress must appropriate the revenues for these functions or allow the funds to be used as general revenues. Because Congress did not enact legislation allocating the windfall profit taxes to specific programs during fiscal year 1981, the net revenues served to reduce the deficit." (Underscoring supplied.)

The \$13.8 billion in net revenues reported by the Treasury Secretary does not represent the then-current balance in Treasury's separate Windfall Profit Tax Account. As mentioned earlier, Treasury is recording gross revenues into the account. Consequently, the fiscal 1981 year-end balance in the account was \$16.2 billion, representing gross windfall profit tax revenues for the year. Thus, the account was overstated by \$2.4 billion.

Although Treasury's procedure of recording gross revenues into the Windfall Profit Tax Account may have had no practical effect during fiscal years 1981 through 1983, proper accounting is still needed. For fiscal year 1984 and/or subsequent fiscal years, the Congress may decide to appropriate windfall profit tax revenues for income tax reductions, low-income assistance, and/or energy and transportation programs.

Moreover, proper accounting for net revenues is important in light of a Presidential proposal for use of those funds. In January 1982, the President proposed that, beginning in fiscal year 1984, windfall profit tax revenues be used to finance a portion of a new federal trust fund. The fund would be used by the states to finance certain federal aid programs that would become their responsibility in 1984. The trust fund would expire in 1991. The President's proposal was not accepted by the Congress. Nevertheless, this proposal to use net windfall profit tax revenues to finance a portion of the proposed trust fund further underscores the need for the Treasury Department to properly account for net revenues.

In sum, the Treasury Department should be recording net revenues into the Windfall Profit Tax Account, as required by law. Should the Congress decide to specifically appropriate windfall profit tax revenues in the future, an account based on net revenues would better serve the appropriations process.

CONCLUSIONS

Due to lower than expected oil price and production levels as well as some recent legislative changes, the windfall profit tax probably will not generate the revenue amounts predicted at the time the law was enacted. Although revenues may not be as high as expected, accurate accounting for the billions already collected and to be collected in the future is important. Proper accounting for net windfall profit tax revenues is important because the Congress intended that the funds be appropriated for three specific purposes--income tax reductions, low-income assistance, and energy and transportation programs. To ensure that net revenues are properly used, the act also requires that they be recorded for accounting purposes into a separate Windfall Profit Tax Account by the Treasury Department. Treasury, however, is recording gross revenues into the account. As a result, the account does not accurately reflect the amount of revenues that can be appropriated for the aforementioned purposes.

RECOMMENDATION

We recommend that the Secretary of the Treasury comply with the accounting requirements of the Crude Oil Windfall Profit Tax Act. Specifically, the Secretary should allocate net windfall profit tax revenues into the established Windfall Profit Tax Account.

AGENCY COMMENTS AND OUR EVALUATION

By letter dated August 26, 1983, the Assistant Secretary for Tax Policy, Department of the Treasury, informed us that Treasury would adjust maintenance of the Windfall Profit Tax Account to conform to the statutory accounting requirement for net revenues.³

Also, the Assistant Secretary stated that the \$227.3 billion which we referred to as a revenue goal in a draft of this report should be identified as a revenue estimate based upon 1980 projections of windfall profit tax receipts. We agreed and made appropriate changes to the report.

Appendix I contains a copy of the Treasury Department's comments.

³In a draft of this report sent to Treasury and IRS for comment, we proposed that the Secretary of the Treasury record net revenues into three subaccounts. These subaccounts would relate to the three purposes for which net windfall profit tax revenues could be appropriated--income tax reductions, low-income assistance, and energy and transportation programs. In Treasury's August 26, 1983, comments, the Assistant Secretary for Tax Policy agreed to establish the subaccounts. Subsequently, however, in a December 5, 1983, letter (see app. VII), the Assistant Secretary informed us that Treasury had decided to maintain only one basic account for net revenues. In follow-up discussions, Treasury Department officials informed us that the subaccount requirement is met through the budget process. That is, the President's annual budget proposal includes a proposed allocation of windfall profit tax revenues for the three statutory purposes. Accordingly, we have made appropriate revisions to the report.

CHAPTER 3

IRS HAS DEVELOPED COMPLIANCE

PROGRAMS FOR THE WINDFALL PROFIT TAX

IRS' enforcement activities for the crude oil windfall profit tax include examining returns, collecting delinquent taxes, assessing penalties, and recommending prosecution of individuals who evade their tax responsibilities. Because the windfall profit tax is a temporary levy and eventually will be phased out, the Service's priority in developing enforcement activities was to establish an examination program. The Service then gave emphasis to Collection Division and Criminal Investigation Division activities to develop an integrated enforcement program.

Through these efforts, IRS has established compliance programs for the windfall profit tax. IRS has made good progress and has adapted its strategies as it has gained experience with the act. Even so, some issues remain unresolved. The Examination Division, for instance, needs a more effective means for selecting oil property operators for examination. This is important because oil property operators play a key role in the windfall profit tax process by providing the basic data necessary for calculating the tax. The Collection Division's efforts have been hampered by nonfiled, incomplete, and inaccurate information returns. These problems need to be resolved because the Service considers such returns essential to enforcing the windfall profit tax with respect to individual producers. Also, the Criminal Investigation Division should increase its visibility in the windfall profit tax program by expanding its efforts to include some self-initiated information gathering projects.

EXAMINATION DIVISION ACTIVITIES--IRS HAS MADE GOOD PROGRESS ALTHOUGH SOME ISSUES REMAIN UNRESOLVED

With enactment of the windfall profit tax in April 1980, IRS moved quickly to develop and implement an examination program. Through early "test" examinations, IRS gained experience which proved useful in refining training materials and developing examination guidelines. From seven test examinations initiated in September 1980, IRS' inventory of open cases grew to 7,075 by September 30, 1983. IRS was able to develop and implement its examination program despite a lack of supplemental funding for windfall profit tax administration.

Despite its early efforts, IRS still faces many problems in implementing its examination program. As discussed in chapter 4, the Service's examiners have encountered technical criteria

difficulties at all phases of the oil production process. In addition, as discussed in this chapter, IRS faces difficulties in

- developing an effective means for selecting oil property operators for examination;
- assuring that the windfall profit tax is assessed and collected on "multiple transaction" oil;
- examining "net income limitation" claims which potentially may involve billions of dollars in windfall profit tax; and
- deciding whether and/or how to recalculate the 1980, 1981, and 1982 windfall profit tax liabilities of oil producers whose state severance tax deductions have been disallowed.

In continuing the progress of its windfall profit tax examination program, IRS needs to overcome these difficulties.

IRS established an early compliance presence through its examination program

Once the law was enacted, IRS quickly began various activities. Recognizing at the outset that windfall profit tax administration would differ significantly from existing programs, IRS

- issued initial regulations and has since revised and supplemented them several times,
- initiated an extensive windfall profit tax training program based in part on experience gained from seven test audits,
- developed and implemented a plan for selecting and examining windfall profit tax returns with a view toward establishing an early IRS enforcement presence, and
- built up a large inventory of examination cases.

On April 4, 1980, 2 days after the act became law, the Federal Register published IRS' temporary regulations providing compliance guidelines to producers, operators, and purchasers of domestic crude oil. IRS received hundreds of pages of comments from the oil industry on the regulations, evaluated those comments, and has since amended and supplemented the regulations several times.

In so doing, IRS opened and has maintained an active dialogue with the oil industry. Maintaining effective communication with oil industry representatives has proven of crucial importance to IRS. For example, many oil company representatives told IRS that the regulations' initial definition of a "first purchaser" was too narrow, was unclear, and did not always mesh with standard industry practice. IRS evaluated those complaints and found that many first purchasers did not always have the information needed to accurately compute and withhold the tax. IRS then broadened the definition--to allow industry greater flexibility in deciding who could act as the tax withholding agent--thus easing the administrative burden on industry while also making it easier to comply with the law.

Furthermore, as discussed in chapter 4, the law required that the Service adopt, on a wholesale basis, many Department of Energy regulations. However, many of the basic definitions contained in the Department of Energy regulations have been challenged in court. Depending on how these lawsuits are resolved, they could affect IRS' tax administration program. We discussed this matter in our report entitled Department of Energy Needs to Resolve Billions in Alleged Oil Pricing Violations (GAO/EMD-81-45, Mar. 31, 1981). In that report, we recommended that the Commissioner of Internal Revenue evaluate the potential effects of these lawsuits on IRS' program, with a view toward taking quick corrective action as necessary. This is but one example of the unique problems IRS faces in seeking to administer the windfall profit tax.

Due to the unique structure of the windfall profit tax, IRS has found it necessary to focus its examinations initially on purchasers and other withholding agents and then subsequently on operators and producers. This strategy requires that IRS deal primarily with sophisticated taxpayers in an industry having specialized operating and accounting practices. IRS, therefore, decided early on that it must use experienced revenue agents, engineers, and computer audit specialists in conducting windfall profit tax examinations. IRS also recognized the need to develop and deliver specialized windfall profit tax training programs.

To meet the needs to develop effective examination approaches and training programs, IRS was able to draw on previously developed expertise regarding the petroleum industry. Specifically, in late 1978, about 2 years before enactment of the windfall profit tax, the Service organized the Petroleum Industry Program in the Southwest region. The program was designed to give special attention to the income taxation of the petroleum industry. On the basis of expertise gained through that program, IRS' Southwest region was delegated much of the

early responsibility for developing nationwide plans for implementing a windfall profit tax compliance program, including training materials for Service personnel.

In September 1980, IRS began examining seven first purchasers' quarterly windfall profit tax returns--all within the Southwest region. These "test" examinations were begun to establish an initial IRS presence and to provide experience for use in refining training materials and developing examination guidelines. By March 1981, the region had trained approximately 475 of its employees. Of these 475 employees, about 400 were revenue agents with the balance composed of employees from other IRS program areas, such as collections, appeals, and criminal investigations. IRS then had to broaden its examination coverage by working trained agents into windfall profit tax examinations as quickly as possible.

In total, IRS planned to initiate some 1,950 audits in fiscal year 1981, involving 265 first purchasers and 1,685 operators. IRS officials believed that these statistics equated to approximate audit coverage levels of 50 percent for first purchasers and 10 percent for operators. Service officials also believed that such coverage levels would very effectively promote voluntary compliance with the law.

Although IRS did not achieve its ambitious fiscal year 1981 examination coverage goals, it did succeed in establishing the early examination presence it sought in the oil industry, especially with respect to large oil companies. Specifically, IRS initiated 744 purchaser and operator examinations and spent 11,577 staff days on those cases during fiscal year 1981. Another 6,335 staff days were expended on windfall profit tax training programs and special projects, such as the development of examination guidelines. Moreover, IRS officials told us that an unanticipated problem--longer than anticipated time frames needed to dispose of previously initiated nonwindfall case inventories--slowed the movement of revenue agents into windfall profit tax cases.

Regardless, examination activity in the windfall profit tax program increased substantially in fiscal year 1982. For example, as of March 31, 1982, the Service had a cumulative inventory of 2,481 open windfall profit tax cases, including examinations of 1,056 first purchasers, 988 operators, and 437 producers.¹ Two IRS regions, the Southwest and Western, had 2,301 cases, about 93 percent of the total. Furthermore, IRS had an inventory of 7,075 examinations in process as of September 30, 1983.

¹Examination case statistics refer to the number of taxable periods (calendar quarters) being examined, not the number of entities or individuals. An entity generally has more than one taxable period under examination.

Thus, IRS has made good progress in developing and implementing an examination program on the windfall profit tax. Nevertheless, there are several key examination-related issues which still need to be resolved. Each of these unresolved issues is discussed separately below.

IRS needs better information
on operators to facilitate
the examination selection process

Oil property operators play a key role in the windfall profit tax process because they supply first purchasers with the basic data, such as oil tier and base price. First purchasers use this data to compute the windfall profit tax. Despite their key role in the process, however, operators generally are not required to file any windfall profit tax returns. Nevertheless, IRS necessarily must promote tax compliance through operator examinations designed to assure that accurate information is supplied to first purchasers. Because operators do not file returns, however, IRS has found it difficult to develop an effective means for selecting them for examination.

IRS planned to initiate examination of 1,685 operators in fiscal year 1981. However, only 208 operator examination cases were actually initiated that year.² One reason for this examination coverage shortfall involved difficulties in developing an effective means for selecting operators for examination.

IRS hoped to achieve broad coverage of high, medium, and low volume operators. Also, IRS wanted to quickly begin detecting operators who had submitted potentially erroneous certifications to first purchasers. Regulations require operators to certify to purchasers all information necessary for the purchasers to compute and withhold the windfall profit tax. This information includes the volume of oil removed, the applicable tax tier, the adjusted base price, the state severance tax, and a property description or designation. To achieve its objectives, IRS planned to rely on first purchaser examinations as the primary means for identifying operators for examination.

First purchaser examinations, however, proved to be of little value as a means for identifying high, medium, and low volume operators. This is because operators can sell oil to a

²As noted earlier, examination case statistics refer to the number of taxable periods (calendar quarters) being examined, not the number of entities or individuals. An entity generally has more than one taxable period under examination.

number of first purchasers and/or because the purchasers often did not segregate operators according to the volume of oil purchased over the course of a year. IRS thus turned to Department of Energy and other reference listings in an effort to obtain that information. However, the Service found that the listings contained only limited information which did not fully meet IRS' needs. In California, for example, the listings did not contain data on the oil volumes generated by individual operators. Los Angeles district examiners thus took the approach of placing phone calls to individual operators in an effort to gather basic data on operators' oil production levels. Some examiners told us that, in their opinion, this approach has done little to promote IRS' credibility with oil property operators. In IRS' Southwest region, many operators were selected for audit on an essentially random basis. Southwest regional officials told us that better data on operators are needed if IRS is to achieve broad examination coverage, as originally planned.

Besides not providing much data on operators' oil production volumes, first purchaser examinations also have been of limited value in identifying operators who have submitted potentially erroneous certifications. In this regard, while examining first purchasers, agents were instructed to make copies of operator certifications which appeared to contain errors. Unfortunately, however, IRS could provide its agents with only limited criteria on which to make such judgments. With respect to base price certifications, agents were provided specific guidance in the form of statistical data on the highest reported prices for particular oil fields. But useful criteria on other certification matters generally were unavailable. For example, regarding oil tier miscertification, there was little that an examiner could do at the first purchaser level to detect potential errors. Recognizing this, IRS guidelines suggested that agents rely primarily on their personal knowledge about certain oil fields and areas of states as a means for detecting errors.

Thus, IRS has experienced difficulties in seeking to develop an effective examination selection process for oil property operators. In January 1983, Southwest regional representatives told us that they were still not satisfied with the selection process even though certain improvements had been made. They said, for example, that they have been able to provide agents with better oil and gas operator information by subscribing to a commercial reporting service. They pointed out that, even so, the information still has several limitations. For example, the reporting service does not cover all oil producing states. Also, a property is generally determined by boundaries that existed in 1972; a subsequent subdivision by a lease does not establish new properties for windfall profit tax purposes. However, the information generally is reported on either a well

or a lease basis, not on a property-by-property basis. Reporting on a property-by-property basis is particularly desirable because it is the "property" which basically establishes the applicable windfall profit tax rate.

Although operators provide key data to first purchasers on a monthly basis, it is not practicable for IRS to obtain and consolidate that data. This is because the data have no common or standard format and because they are widely dispersed. There is, for example, no required form or format that operators must use in providing windfall profit tax computational data to purchasers. Moreover, portions of oil production from a given property may be sold to several different purchasers. Also, the industry practice of trading or exchanging oil--a practice discussed more fully in the next section of this report--would further complicate the data collection and consolidation process. For these reasons, it would be very difficult for IRS to obtain the data from purchasers and then consolidate the data by operators and oil properties.

Thus, IRS lacks the basic data it needs to develop an effective process for selecting oil property operators to examine. One means for remedying this problem, according to IRS Southwest regional representatives, would be to require that operators file an annual information return with IRS, containing basic data on oil production, oil tiers, base prices, severance taxes, and properties. In this regard, the Secretary of the Treasury has the appropriate regulatory authority under section 4997(a) of the Internal Revenue Code, which states that

"Each . . . operator of a well from which domestic crude oil was produced, shall keep such records, make such returns, and furnish such information . . . with respect to such oil as the Secretary may by regulations prescribe."

We recognize that such a filing requirement would impose an added paperwork burden on the oil industry. And, IRS should consider this burden in deciding whether to initiate such a requirement. Perhaps there are other ways to deal with this problem. However, the windfall profit tax is a temporary levy and IRS needs to develop an effective examination selection technique for operators very quickly. Furthermore, operators already supply first purchasers with extensive information on windfall profit tax transactions. Providing similar information to IRS thus should not pose a substantial additional burden on operators.

Assuring that the windfall
profit tax has been assessed
and paid on oil involved in
multiple transactions is
a difficult task

Besides experiencing difficulties when seeking to select operators for examination, IRS also is experiencing difficulties in seeking to assure that the windfall profit tax has been assessed and collected on oil involved in multiple transactions.

When IRS conducts an examination of a first purchaser, it often identifies oil purchases on which the buyer withheld no windfall profit tax. In such instances, the purchaser may inform IRS that it had purchased the oil from a reseller, middleman, or oil trader and thus was not the first purchaser of the oil. Because a given quantity of oil can change hands many times, IRS is experiencing difficulty in seeking to assure that the windfall profit tax has been assessed and paid on such oil. Similar problems confronted the Department of Energy in prior years when it sought to enforce price controls on oil involved in multiple transactions. To avoid a repetition of those problems, Treasury and IRS need to initiate action directed at assuring accountability for the windfall profit tax at all stages of the oil production and marketing process.

Generally, oil-purchasing entities are responsible for withholding the windfall profit tax on all oil transactions in which they are the first purchaser. In some instances, however, it is very difficult for IRS examiners to determine who was the first purchaser of certain oil and whether any tax was withheld. These instances center around multiple transactions (sales and trades or exchanges) of the same oil and usually involve middlemen or resellers, whether they be the traditional oil gatherers such as pipeline and trucking companies or the more recent kind of oil middlemen, the oil traders, who made their appearance with the advent of price controls. In this regard, a given quantity of oil may have exchanged hands 15 to 30 times before finally being obtained by the purchaser that IRS is examining. For example, revenue agents in the Service's Houston district encountered one case where ownership of the same oil changed 32 times within a 3-day period.

Multiple transactions present IRS a very demanding resource-utilization challenge. Compounding this challenge is the lack of data on the size of the problem. As of August 31, 1983, the Service had not attempted to estimate the annual volume of multiple transaction oil, so it is difficult to quantify the size or extent of the problem. Similarly, the Department of Energy did not quantify the universe of multiple transaction oil during the period for which price controls were in effect. The

Department did, however, review certain practices involved in the buying, selling, and exchanging of title to crude oil transported by selected pipelines.

The Energy Department's unofficial results, based on a review of a limited number of pipelines, pointed to a conclusion that some refiners and resellers had used transfers within the pipeline to recertify low-priced crude oil as high-priced oil. More specifically, preliminary review results indicated the following:

- During regulated periods, especially after 1976, some refiners made increasingly large volumes of domestic low-priced crude available for transfer within the pipeline to resellers.
- Low-priced crude oil was bought, sold, and exchanged by many different resellers, some of whom may have sold it more than once in a given month, even though the oil's ultimate destination remained unchanged.
- Resellers ultimately transferred the low-priced crude oil to the same refiners who had made it available for transfer within the pipeline but certified it as high-priced foreign or stripper crude oil.

These observations were based on limited Department of Energy inquiries into pipeline transfers and should not be taken to imply widespread industry irregularities. Many purchases, sales, and exchanges of title to crude oil transported by pipelines have valid business purposes. Before the advent of price controls on crude oil and petroleum products, for example, pipeline companies provided a means by which purchasers could transfer title to the crude oil transported. This system of in-line transfer was termed "reconsignment" in the pipeline tariff rules and occurred when a shipper transferred title of the crude oil to another firm before the oil reached its destination.

Originally, this system was developed primarily to accommodate crude oil shippers when they or their consignees at the pipeline destination had operational problems. These problems included crude oil production difficulties, delays or disruptions in crude oil supply, and refinery processing interruptions. Accommodation sales allowed the distressed refinery to minimize the impact of such events. However, after price controls began, a number of new entities emerged as crude oil resellers and the volume of accommodation transfers reportedly increased significantly and, as indicated below, may have been designed to circumvent energy regulations.

In any event, the Department of Energy's progress toward resolving alleged crude oil reseller pricing violations has been limited. We have reported several times on the Department's lack of progress in this area. For instance, a May 29, 1979, report to the Congress was entitled Improvements Needed in the Enforcement of Crude Oil Reseller Price Controls (GAO/EMD-79-57). In that report, GAO found that the Department had not given adequate priority to audits of crude oil resellers. A followup report (GAO/EMD-81-45) issued March 31, 1981, noted that audit coverage had improved and that the Department's Office of Enforcement had identified crude oil reseller violations in excess of \$500 million. However, the report also noted that the Office had not processed proposed remedial orders on charges against crude oil resellers, even though many of the charges were over 1 year old. Even more recently, a June 1, 1982, report was entitled Department of Energy Has Made Slow Progress Resolving Crude Oil Reseller Pricing Violations (GAO/EMD-82-46).

IRS acknowledges that reseller oil presents a very difficult examination problem. Typically, in order to fulfill their tax-withholding responsibility, first purchasers keep very detailed records on oil purchased directly from oil property operators. In contrast, for oil obtained from resellers, the subsequent purchaser generally has no withholding obligation. Consequently, the subsequent purchaser's records contain little more than basic invoice data--price and quantity--and give no indication as to the identity of the first purchaser or the producers ultimately responsible for the tax. This means that there is no easy way to examine reseller or multiple transaction situations. Each quantity of oil literally must be traced back through a series of transactions and owners to determine if the tax was withheld.

This is very demanding on IRS resources. The various buyers and sellers involved in multiple transactions may be located in different parts of the country. Thus, tracing often requires coordinated examination assistance from several IRS districts and regions. Procedurally, cross-district and cross-region examination assistance can be obtained presently via three methods, each of which has practical limitations.

- One method is for revenue agents to prepare an Examination Information Report (Form 5346), which is, in effect, a potential examination lead or suggestion. The receiving district office may or may not open an examination on the suggested entity, depending on its own workload. In any event, the information report route is perhaps too slow and cumbersome to meaningfully track multiple exchanges.

--A second method for obtaining coordinated assistance is for a district to request concurrent examination help from another district. This is referred to by IRS as "collateral" examination. However, some IRS field office representatives think this approach is not viable because collateral work is not recorded as direct examination time. Since many of the Service's internal goals and objectives are measured in terms of direct examination time, district offices may be reluctant to support much collateral assistance.

--A third method is one of informal cooperation. One district's coordinator for examinations can simply pick up the phone and ask another district's coordinator to open an examination on a specific company. This approach is being used by district offices in IRS' Southwest region. There are some concerns within IRS, however, as to whether this informal approach will work on a consistent basis.

Thus, IRS has developed several methods through which it seeks to deal with the problem of multiple transaction oil. No one method has been without problems, however. Accordingly, within the Service, there has been some discussion of a need for a "tax-paid" certificate. Such a certificate would accompany oil to the refinery, particularly oil purchased from resellers or suppliers, and would serve as evidence to IRS that the wind-fall profit tax has been paid. Further, the certificate could identify the relevant parties.

In our view, in light of the Department of Energy's experience under price controls, serious consideration should be given to a requirement for a tax-paid certificate or some similar form of documentation. Some IRS officials believe that legislative authority for Treasury to require such a document is provided in section 4997(a) of the Internal Revenue Code, which states that taxpayers, purchasers, and operators "shall keep such records, make such returns, and furnish such information" as the Secretary of the Treasury may prescribe by regulations. However, other IRS officials think this statutory provision is not broad enough to cover all the entities and individuals involved in multiple transaction oil--some of whom may not be a taxpayer, purchaser, or operator. Regardless, we think the issue has sufficient potential for Treasury and IRS to proceed officially in determining the need for such a certificate. In so doing, Treasury and IRS should consider the burden of this requirement on industry. If such a certificate is deemed necessary and appropriate, either regulations should be promulgated or, if needed, legislation should be sought.

The net income limitation presents
unique and severe difficulties,
especially in examination
of large companies

Besides problems with multiple transactions relating to the same oil, IRS also needs to develop an approach for dealing with problems it encounters when seeking to examine net income limitation claims. In this regard, by law, the taxable windfall profit on a barrel of oil is limited to 90 percent of the net income attributable to that barrel. This legal provision has the effect of helping to assure that the windfall profit tax does not render oil production unprofitable. It does so by taking producers' costs into account and providing for a 10 percent margin of profit that goes untaxed for windfall profit tax purposes (for example, see app. III, table 9).

In applying the net income limitation, the net income attributable to a barrel of oil is determined by dividing the taxable income from the property by the number of barrels of oil produced from the property. Taxpayers calculate their average net income per barrel of oil by dividing the total taxable income (for income tax purposes) from the property by the total number of barrels of oil removed. Taxable income from the property is generally determined under the percentage depletion rules of section 613(a) of the Internal Revenue Code.

This net income limitation provision creates unique and severe difficulties for IRS. The claims or adjustments of large oil companies involve calculations of such volume and complexity that examiners face formidable tasks. For instance, some claims may have hundreds of pages of supporting documents. Moreover, the necessity to examine both excise tax and income tax records when conducting a complete windfall profit tax audit presents IRS cross-district and cross-tax-year coordination problems.

Cross-district coordination may be required because a taxpayer's windfall profit tax and income tax records may be located in different areas of the country. Also, because windfall profit tax examinations generally are about 3 years more current than corporate income tax examinations, cross-tax-year coordination is needed to avoid duplication of effort and its possible effects--inconsistencies of results, inequities to taxpayers, and strained IRS-taxpayer relations.

For these reasons, and because the net income limitation provision potentially involves billions of dollars, IRS needs to devote considerable attention to developing effective examination procedures.

The provision is unique,
linking windfall liability
to income tax elements

Taxpayers can avoid or recover overwithheld windfall profit taxes based on the net income limitation in several different ways. For instance, taxpayers who withhold tax on their own production, and file Form 720 excise tax returns, can estimate the effect of the net income limitation each quarter and reduce tax payments accordingly. Alternatively, taxpayers can obtain a year-end refund by completing and filing a Form 843 claim. Or, taxpayers may show a tax credit on the annual individual or corporate income tax return. In any case, taxpayers summarize the supporting net income limitation calculation on Form 6249 (Computation of Overpaid Windfall Profit Tax) and file it with the respective return or claim.

To verify the correctness of the net income limitation claim, revenue agents must review the taxpayer's income tax records to determine whether all claimed expenses are allowable and whether the taxpayer has properly allocated overhead among the properties. The revenue agent must review the historical production and reserves records and must analyze random samples of income and expenses related to each property involved in the claim for the tax year. Furthermore, if the samples reveal problems, more work has to be done.

IRS faces a major challenge in examining the net income limitation claims of large oil companies. IRS has estimated that about 80 percent of total windfall profit tax liability will fall on 35 major oil companies. These major oil companies have begun requesting the refund of billions of dollars. Several of these large companies had refund claims or adjustments based on the net income limitation which totaled more than \$200 million per company for calendar year 1980. Because of the large sums of money involved, inadvertent or inappropriate misallocations of income and expenses can significantly reduce windfall profit tax liability. Consequently, the Service must maintain a concerted effort in this area.

An IRS official told us that, as of January 1983, most of the major oil companies had filed claims for refund of large portions of their calendar year 1980 windfall profit taxes. The official added, however, that the oil companies have experienced internal accounting problems in this area. In particular, the companies have experienced difficulties reconciling their accounting records with the records maintained by the numerous intermediate withholding agents. As a result, many of the major companies have found it difficult to prepare and file accurate and complete refund claims. In fact, some IRS officials believe

that the net income limitation claims already filed by many of the major oil companies are only partial claims for calendar year 1980. That is, the claims cover only those oil producing properties for which the companies have been able to reconcile records. Thus, on the basis of this observation, the Service believes that additional net income limitation claims for refund of 1980 windfall profit taxes may be forthcoming.

IRS' experience with the claims that have been filed indicates that the Service will have difficulty verifying the voluminous and complex calculations and coordinating its efforts between different districts and different tax years.

Calculations are numerous and complex

In the case of all large oil producers, the numerous and complex calculations needed to support a net income limitation claim place a substantial burden on IRS resources. These voluminous and complex calculations are a significant burden for the taxpayer to prepare and also present a laborious task for the revenue agent. To illustrate:

--One Form 6249 (Computation of Overpaid Windfall Profit Tax), received from a major oil company, claimed \$206.9 million of overpaid windfall profit tax based on the 90 percent net income limitation. Attached to the Form 6249 were 782 pages of computations made on approximately 5,450 properties.

--IRS received a net income limitation claim for approximately \$252 million in overpaid tax. The claim had 2,500 pages of supporting documents. IRS officials estimate that it would take four revenue agents over a year to reconcile the claim.

One of the major areas of computational complexity is the tax concept of depletion for income tax and windfall profit tax purposes. Generally, depletion is a deduction from gross income provided by the Internal Revenue Code to compensate the taxpayer for exhausting the oil and gas reservoir. For income tax purposes, the code provides two methods of computing the depletion allowance--cost depletion and percentage depletion. Cost depletion provides a deduction for the taxpayer's costs to develop the oil and gas property in relation to the production and sale of minerals. On the other hand, percentage depletion is a statutory concept, which provides for a deduction of specified percentages of the gross income from the property.

For windfall profit tax purposes, the tax concept of depletion has yet another layer of complexity. That is, for purposes of applying the "90 percent of net income limitation" under the Windfall Act, neither cost depletion nor percentage depletion may be deducted from taxable income. However, a deduction is allowed for "imputed" or "as if" cost depletion. Usually, as the name implies, this is a reconstructed figure and represents the cost depletion that would have been allowable "if" (1) all intangible drilling costs and certain other expenses incurred by the taxpayer for the property had been capitalized and "if" (2) the taxpayer had used cost depletion with respect to the property for all taxable periods.

In many instances, these calculations will be based on information obtained from a third party, i.e., from someone who previously owned the property and accounted for the depletable basis of the oil reserves. To determine the accuracy of the taxpayer's information, the examining agent may have to enlist the services of an IRS petroleum engineer. And, in some instances, it may be necessary to make a time-consuming examination of third-party records.

Cross-district and cross-tax-year
coordination of examinations
is required

Examining the income tax records of oil companies for windfall profit tax purposes is a difficult task to coordinate, especially for companies classified as "large case" taxpayers. Large case taxpayers refer to those companies included in the Service's Coordinated Examination Program for income tax purposes. Taxpayers in the Coordinated Examination Program usually have division/subsidiary operations in several geographic areas and require a coordinated examination effort among IRS district offices. These large case taxpayers are routinely scheduled to have each tax year audited for income tax purposes. Nationwide, approximately 105 oil and oil-related companies, including the 35 or so majors, are scheduled in the Coordinated Examination Program. According to IRS officials, nearly all of these companies are involved in oil exploration and probably will make use of the net income limitation provision.

Since large case taxpayers usually have operating divisions or subsidiaries in different geographic areas, excise and income tax records may be located in different IRS districts and regions, creating a need for cross-district coordination of IRS examinations. Federal excise tax returns (Forms 720) are normally filed at the IRS service center which serves the geographic area where the company's oil-producing division or subsidiary is located. Consequently, many large companies file

consolidated income tax returns in one district but file windfall profit tax returns (through an operating division or subsidiary) in another district. In these instances, verification of claims involving the net income limitation at the location where the Form 720 excise tax return was filed will not be possible without the income tax records which are located in another area of the country.

To illustrate, a parent company may have its corporate headquarters in Chicago where most of its income tax records are kept. It files a consolidated income tax return covering 85 subsidiaries with IRS' Cincinnati Service Center. However, the federal excise tax returns (Forms 720) are filed by subsidiaries in Tulsa and Houston with IRS' Austin Service Center. And the windfall examinations would be conducted by IRS' Oklahoma City and Houston district offices. This situation is not limited to large case taxpayers but can occur whenever a taxpayer's excise and income tax records are located in different IRS districts.

While there are no standard procedures for coordinating net income limitation examinations on out-of-district taxpayers, the Service anticipates that the work will be done using a support approach. Under such an arrangement, the district having primary jurisdiction over an examination will request another district to open a support or assist examination. Given the fact that relatively few net income limitation claims had been filed by large companies and/or examined by IRS as of January 31, 1983, it is too early to assess the viability of this approach. Nevertheless, IRS has limited examination resources, and support requests must compete with the receiving district's own tax administration workload.

Further, besides presenting cross-district coordination difficulties, net income limitation examinations require cross-tax-year coordination to avoid duplication of effort and its possible effects, such as inconsistencies of results, inequities to taxpayers, and strained IRS-taxpayer relations.

Current IRS procedures for conducting net income limitation and large case income tax examinations can result in duplication of effort by having two different audit teams review the same income tax records. Large case income tax examinations typically run 3 years behind the current tax year. Presently, for instance, IRS agents are examining the 1978 and 1979 income tax years. However, the examination cycle for the windfall profit tax is much shorter, with examinations covering the current calendar year to allow time to allocate related tax adjustments to other producers within the statute of limitations. Consequently, a large case taxpayer could have his income tax records reviewed once during the current tax year by a windfall examination team and again 3 years later by a large case income tax examination team.

In addition to possible duplication of work, the Service runs the risk of having the windfall examination team allow certain expenses relating to a property in computing the net income limitation, only to have the subsequent examination team disallow them for income tax purposes. Also, making two reviews of the same income tax records may seem inequitable to the affected taxpayer and, thus, could strain IRS-taxpayer relations. According to IRS, many taxpayers have objected to windfall profit tax agents looking at current income tax records to verify the net income limitation.

Even smaller companies have raised concerns about windfall profit tax agents reviewing income tax records. According to one IRS official, "the gravest area of concern is that the majority of taxpayers . . . are not going to readily comprehend our position that this is a windfall profit tax audit only." The paraphrased comments of another IRS official who described the problem are as follow:

--In the course of examining a claim based on the net income limitation, the IRS agent will ask to see the taxpayer's income tax records. The taxpayer questions the request as going beyond a windfall profit tax audit. The agent has to try to explain that while it is a windfall profit tax audit, the Service needs to review income tax records in order to verify the net income claim calculations. Unfortunately, the perception is that IRS is auditing both windfall profit and income tax.

In order to avoid duplicative reviews of income tax records, and the associated adverse effects, one IRS district office has suggested two possible approaches, which are paraphrased as follows:

--One option is to have the large case income tax team expand its coverage to include the net income limitation of the windfall profit tax years currently under examination. That is, in effect, the income tax team would perform a support assignment for the windfall profit tax program. Workpapers from examining the net income limitation could be prepared in a manner permitting their retention and later use in the income tax examinations of the respective years.

--A second option is to establish a special task force within a district office's large case examination branch to work the net income limitation on large companies. Here again, net income limitation workpapers could be prepared in such a manner so they could be used in future income tax examinations.

While both options provide for consistent treatment of income tax issues and eliminate duplication, some IRS officials point out at least one serious problem with these proposed solutions. That is, using large case revenue agents to examine net income limitation claims will adversely affect large case or Coordinated Examination Program goals through loss of personnel and expertise. And, as previously noted, large case income tax audits are already running 3 years behind the current tax year.

The fact that there appears to be no easy or problem-free method for conducting net income limitation examinations does not diminish the need for uniform procedures to resolve the cross-district and cross-tax-year coordination problems discussed above. Presently, though, the Service's position is to give district offices flexibility in handling such examinations. However, the lack of standardized procedures leaves IRS district offices without guidelines for coordinating the Service's access to and use of the same records for dual purposes--windfall profit (i.e., net income limitation) and income tax examinations. IRS needs to develop uniform procedures to eliminate possible duplication of effort and the related adverse effects of such duplicative efforts.

The tax liability effects
of disallowed state severance tax
adjustments need to be assessed

Another area which IRS needs to address concerns the windfall profit tax liability effects of certain disallowed deductions for state severance taxes. Such taxes are deductible for windfall profit tax purposes--but only if they meet certain specific legislative criteria.

Some of the severance tax adjustments used by oil companies for windfall profit tax purposes since March 1980 were disallowed by recent IRS revenue rulings. Now, the Service needs to analyze the tax liability effects of these rulings and, if practical, make appropriate adjustments to taxpayers' windfall profit tax liability.

Most states with nonrenewable natural resources, such as oil and gas, impose a severance tax on either the value or quantity of resources extracted. The major oil producing states have had oil severance taxes since the early 1900s. For example, the Texas legislature first enacted an oil severance tax in 1905; Louisiana imposed a tax in 1910; and Oklahoma followed soon after, enacting a gross value severance tax on oil in 1916. Now, about 32 states impose severance or similar taxes on natural resources extracted within their respective geographic boundaries.

The constitutional permissibility of such severance taxes is well established. States have a good deal of freedom in taxing the production and processing of natural resources, although the federal Constitution's commerce clause does pose certain limitations. Generally, a state may tax oil and gas produced within its borders until the products enter the "stream of interstate commerce," i.e., the point at which production and processing cease and transmission in interstate commerce begins. In interpreting the commerce clause, the Supreme Court has tried to strike a balance between two interests: (1) the national interest in preventing states from establishing taxation patterns that unfairly discriminate against or are unduly burdensome upon interstate commerce and (2) the host state's interest in compelling interstate commerce to "pay its own way."

In short, while state power to tax natural resources has not been preempted by federal law, the commerce clause prohibits states from taxing products that are in interstate commerce and from imposing taxes which have a substantial effect on interstate commerce. Under these legal parameters, most states tax oil and gas produced within their respective borders.

The Congress was aware of state severance taxes in drafting the Crude Oil Windfall Profit Tax Act. Accordingly, the act provides for a severance tax adjustment in calculating windfall profit tax liabilities. The severance tax adjustment is the amount by which any qualified state severance tax imposed on a barrel of crude oil exceeds the severance tax which would have been imposed if the oil had been valued at its adjusted base price. An example computation of the severance tax adjustment is shown by table 7 in appendix III.

To qualify as an adjustment in computing the windfall profit tax, each state's severance levy must meet four tests. First, the charge must be a "tax." Generally, a payment for some special privilege granted or service rendered would not qualify. Second, the tax must be imposed by a "state;" severance taxes imposed by political subdivisions (county, municipality, etc.) do not qualify. Third, the tax must be imposed on the "extraction" of oil. Hence, a tax levied on the value of reserves is not a severance tax. Fourth, the tax must be based on the "gross value" of extracted oil. That is, the tax must be determined on an ad valorem basis such as a percentage of the oil's selling price. A fixed tax rate of so many cents or dollars per barrel does not qualify.

Even given these tests, questions still arose about whether certain states' taxes qualified for the deductible adjustment in calculating the windfall profit tax. The need to resolve which states' severance taxes qualify for the windfall profit adjustment was highlighted as early as June 1980 by several oil

companies in their formal comments to Federal Register notices of proposed rulemaking. However, IRS was unable to publish revenue rulings on this matter until May 10, 1982. The published rulings discuss the allowability of a windfall profit tax adjustment for severance taxes imposed by 22 states. Some of the severance tax adjustments used by oil companies over the previous 2-1/2 years were disallowed by the May 1982 IRS revenue rulings. Now, the Service needs to analyze the tax liability effects of these rulings and, if practical, make appropriate adjustments to taxpayers' windfall profit tax liabilities.

Of the 22 states discussed in the May 1982 revenue rulings, 10 states were determined to have one or more taxes which do not qualify for the adjustment allowed by the Crude Oil Windfall Profit Tax Act. These states are Alaska, Arkansas, California, Colorado, Idaho, Louisiana, Nevada, Ohio, Texas, and West Virginia.

This is not to imply that all of the taxes disqualified in each of these states now present IRS a problem in terms of a need to make windfall profit tax adjustments for past periods. Some of the state taxes disallowed by the IRS revenue rulings probably were never used by first purchasers and other withholding agents. For instance, some of the disallowed taxes are imposed by the states at a "fixed fee" per barrel. As mentioned earlier, one of the four tests established by the Crude Oil Windfall Profit Tax Act is that a state levy must be on an "ad valorem" basis to qualify for the windfall profit tax adjustment. Because this is a fairly clear standard, it can be expected that few or no first purchasers and other withholding agents used a "fixed fee" state tax in computing windfall profit tax liabilities.

On the other hand, for a few states, the May 1982 revenue rulings do affect producers' windfall profit tax liabilities for the 1980 and 1981 tax years and part of 1982. For example, this is the case in Colorado where approximately 29 million barrels of crude oil are produced annually. Generally, before the applicable May 1982 revenue ruling, most oil companies in Colorado used a standard rate of 0.0309 per dollar value of crude oil removed to adjust windfall profit taxes. This rate was the aggregate of a conservation tax (0.0009) and a severance tax (0.0300). However, IRS has ruled that the latter Colorado tax does not constitute an allowable adjustment for windfall profit tax purposes.

The effect of this ruling is that windfall profit tax has been underwithheld for producers of Colorado crude oil. The following table illustrates this effect on a per barrel basis. As shown in the example, underwithheld windfall profit tax is

\$0.15 a barrel at the 30 percent tax rate (\$5.09 minus \$4.94), and \$0.36 a barrel at the 70 percent tax rate (\$11.89 minus \$11.53). On the basis of yearly production of about 29 million barrels, the projected additional windfall profit tax due the government could be from \$4.35 million to \$10.44 million a year. This illustration, while hypothetical, is not unrealistic in terms of effect because we used oil price and production data representative of the relevant period.

Table 2

Example of Comparative Windfall Profit Tax Withholding
Based on Different Severance Tax Rates^a

	Colorado Taxes	
	Unallowable rate (0.0309)	Allowable rate (0.0009)
Removal price per barrel	\$30.00	\$30.00
Less: adjusted base price	(13.00)	(13.00)
	17.00	17.00
Times: severance tax rate	x 0.0309	x 0.0009
Severance tax adjustment	\$0.53	\$0.02
Removal price per barrel	\$30.00	\$30.00
Less: adjusted base price	(13.00)	(13.00)
severance tax adjustment	(0.53)	(0.02)
Windfall profit	\$16.47	\$16.98
Windfall profit tax:		
at 70% rate	\$11.53	\$11.89
at 30% rate	\$4.94	\$5.09

^aExcept for the severance tax rates and the windfall profit tax rates, the numbers used here are illustrative only.

Because the adjustment cut-off period for first purchasers and other withholding agents to correct withholding errors on 1980 and 1981 oil production has passed, IRS is faced with having to make many needed tax liability adjustments for those years. Administratively, it will be very difficult for IRS to adjust the windfall profit tax liability for the thousands of producers involved. Regardless, the Service needs to analyze the tax liability effects of its May 1982 revenue rulings and decide whether adjustments to affected taxpayers' windfall profit tax liability can and should be made for past taxable periods. As the table shows, even a relatively small change in the severance tax adjustment can substantially affect total windfall profit tax liability when millions of barrels of oil are involved.

COLLECTION DIVISION ACTIVITIES--COMPLIANCE
EFFORTS ARE UNDERWAY, BUT NONFILED,
INCOMPLETE, AND INACCURATE INFORMATION
RETURNS HAVE CAUSED PROBLEMS

IRS' Collection Division, which is responsible for identifying delinquent taxpayers and collecting delinquent taxes, early extended its traditional compliance activities, such as use of the federal tax deposit alert system, to the windfall profit tax. However, the Division's ability to structure an effective compliance program for identifying delinquent windfall profit taxpayers depends largely on the availability, completeness, and accuracy of annual information returns. The first purchaser of crude oil is required to annually report windfall profit tax liability to each taxpayer and to IRS on Form 6248 (Annual Information Return of Windfall Profit Tax). Analogous to the W-2's importance in ensuring compliance with the personal income tax, the Form 6248 annual information return serves as IRS' major windfall profit tax compliance document. However, statistics for the 1980 tax year indicate that nonfiling of Form 6248 was a significant problem. In addition, of the Forms 6248 filed for tax year 1980, many were incomplete or erroneous.

Given the importance of the annual information return to IRS' windfall profit tax compliance program, Congress, as part of the Technical Corrections Act of 1982 (P.L. 97-448, Jan. 12, 1983), enacted a penalty for failure to file Form 6248. The penalty may also extend to certain incomplete returns. Earlier, the Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248, Sept. 3, 1982) increased the penalty for failure to supply identifying numbers on information returns. Together, these penalties should help IRS improve compliance in this important area. Besides using the new penalty, IRS also can promote better compliance by identifying and correcting inaccurate information returns during first purchaser examinations.

The Collection Division has sought
to establish a compliance program
for the windfall profit tax

IRS' Collection Division is responsible for collecting delinquent windfall profit taxes. Taxpayers are delinquent if they fail to file returns, file returns but do not pay the required taxes, or file incorrect returns which understate their tax liabilities. The Collection Division carries out its windfall profit tax responsibilities through routine monitoring of federal tax deposits and through programs specially developed for the windfall profit tax.

The Collection Division has made good progress in monitoring deposits of windfall profit taxes. On the other hand, the Division has not been as successful in developing special compliance programs--primarily due to nonfiled, inaccurate, and/or incomplete information returns.

The federal tax deposit alert system is in place and is working

One of the Collection Division's traditional compliance activities involves use of the federal tax deposit alert system. As the name implies, the purpose of this system is to "alert" the IRS to the fact that a regular or previous tax depositor has not deposited for the current tax period. The first issuance of federal tax deposit alerts for windfall profit tax deposits was for the quarter, April-June 1981. For that and the next quarter, a total of 17 alerts were issued for windfall depositors in IRS' Southwest region. On the basis of its investigations, the region recommended continuation of the federal tax deposit alert program for windfall taxes because, even though the number of cases (two delinquencies) was small, the quarterly tax liabilities involved were relatively large, over \$1 million in one instance.

To reiterate, the purpose of the deposit alert system is to help assure that federal taxes will be paid on a current basis. The system permits revenue officers to contact taxpayers before the applicable return is due. This early contact benefits both IRS and taxpayers. Corrected deposits lessen the potential number of taxpayer delinquent accounts which have to be established, controlled, and investigated by IRS personnel. And, by promptly following up on deposit alerts, IRS provides taxpayers an opportunity to correct deposit deficiencies, thereby precluding the need for taxpayers to pay a large accrued tax balance at a later date.

To supplement this activity, IRS has sought to develop some special compliance programs. Such specially developed collection activities are referred to as returns compliance programs.

Returns compliance programs for the windfall profit tax

Returns compliance programs are designed to identify taxpayers who are not on IRS' master files for a particular type of return but who are required to file. Ideas for a given compliance program may come from a variety of sources--from newspaper articles and other publications as well as from IRS employees. Successful programs produce taxpayer delinquency investigations, taxpayer delinquent accounts, and subsequent collection of additional revenues.

The Collection Division, as of January 1983, had designed six returns compliance programs for the windfall profit tax. Some of the programs are designed to determine compliance with the requirement to file Forms 720--quarterly excise tax returns. These programs are directed, respectively, at "qualified dis-bursers," "electing operators," the first purchasers of oil produced in one state (Texas), and certain producers found by IRS not to be exempt from windfall profit tax. Development and implementation of other programs have been hampered by nonfiled, inaccurate, and incomplete information returns. Each of the six programs is discussed below.

Initially, two returns compliance programs were tested in the Southwest region during September through December 1981. The programs were directed at determining whether "qualified dis-bursers" and "electing operators" were complying with windfall profit tax requirements in filing quarterly Forms 720 excise tax returns. Qualified dis-bursers are intermediate dis-bursers of oil sales proceeds who elect, in accordance with regulations, to act as withholding agents. The regulations also allow operators, in some instances, to elect to act as withholding agents. The programs generally found that dis-bursers and operators were complying with the law. Accordingly, the Southwest region recommended that the returns compliance programs for qualified dis-bursers and electing operators not be expanded nationwide.

A third returns compliance program to detect nonfilers of Form 720 quarterly returns is based on oil purchaser identification data reported by a commercial service. The objective of the program is to identify oil gatherers (purchasers) who have not filed quarterly excise tax returns for windfall profit tax. As of January 1983, the program was limited to oil produced in Texas only. IRS had determined that 246 entities purchased Texas oil in calendar year 1980 and that, of this number, 68 had not filed quarterly excise tax returns. However, IRS collection personnel have further determined that most of these 68 entities are transporters of crude oil, not first purchasers, and are not required to file quarterly returns. An IRS Collection Division official told us in January 1983 that this particular compliance program, which is based on data reported by a commercial service, probably will not be expanded to oil production in other states.

A fourth returns compliance program is directed at certain producers who claimed an exemption from windfall profit tax. As table 8 in appendix III points out, some governmental, charitable, and other organizations qualify for exemption from the tax. To obtain this exemption, producers must file a Form 6458 (Certification and Election) with IRS' Austin Service Center. In screening these forms, service center staff identify some producers who may not qualify for exemption. Consequently,

IRS has an ongoing returns compliance program directed at these potentially nonexempt producers with a view toward assuring that the applicable excise tax returns are filed.

Under this returns compliance program, the Austin Service Center initially issued 58 investigative leads on September 30, 1982, as follows:

<u>IRS region</u>	<u>Number of potentially nonexempt producers</u>
Southwest	31
North-Atlantic	12
Western	9
Midwest	3
Mid-Atlantic	2
Central	1
Total	<u>58</u>

As of January 1983, IRS had not compiled the results of these initial leads. As stated earlier, however, this particular collection program is a continuing effort. In fact, the Austin Service Center has generated a total of about 474 investigative leads for various district offices through February 1984.

The remaining two returns compliance programs both involve use of Form 6248 (Annual Information Return of Windfall Profit Tax). IRS officials consider Form 6248 information returns essential to enforcing the windfall profit tax with respect to individual producers. Regulations provide that withholding agents must furnish each payee and IRS an annual information return, showing the volume of crude oil removed during the calendar year, the applicable windfall profit tax liability, and the amount of withheld tax.

The Service early planned to initiate a returns compliance program to detect instances of nonfiled Form 6248 annual information returns. But the program was suspended because, until January 1983, the Internal Revenue Code did not provide any penalty for failure to furnish annual information statements to payees or to IRS. However, effective January 1, 1983, the Technical Corrections Act of 1982 provides a civil penalty for nonfiling. Therefore, the Service is now proceeding with this returns compliance program.

In its early planning, IRS estimated that it would receive about 4 million Form 6248 information returns for calendar year 1980. Recent counts show actual receipts of only around 2.56 million, however. IRS officials believe the absence of a penalty led to nonfiling decisions by many taxpayers. Consequently, in July 1981, IRS' Southwest region recommended that

the national office initiate a legislative proposal to establish a civil penalty for nonfiling of windfall profit tax information returns. IRS' national office subsequently developed and forwarded to Treasury a legislative proposal in this regard.

The Congress enacted such a penalty as part of the Technical Corrections Act of 1982. The act specifically provided for a \$10 failure to file penalty for each Form 6248 information return not filed, not to exceed \$25,000 per person in any calendar year.

The other returns compliance program using Form 6248 information return data involves trying to identify underwithheld producers. The Forms 6248, which are prepared annually by purchasers and submitted to producers and to the IRS, show tax liability and tax withheld. If liability exceeds withholding, the producer must file an annual Form 720 excise tax return and pay the difference.

In an effort to determine whether underwithheld producers had complied with this requirement for tax year 1980, the Service's National Computer Center matched the inventories of Forms 6248 and 720. About 3,000 potential nonfilers of annual returns were identified, and collection personnel are following up on those leads. IRS' Southwest region received about 69 percent of the leads issued nationwide. On the basis of these leads, the region's revenue officers secured 139 delinquent returns, representing \$169,685 in delinquent windfall profit taxes.

Besides securing delinquent returns and taxes, Collection Division officials believe that the public contacts have had the effect of improving voluntary compliance. For instance, Service officials informed us that, during the time IRS revenue officers were working on leads for delinquent 1980 returns, a taxpayer who was not on the discrepancy matching list voluntarily came into a district office and paid about \$1.5 million in delinquent windfall profit taxes.

On the other hand, IRS was unable to do the matching exercise for about 12,000 cases for tax year 1980 because of a systems problem. That is, these 12,000 leads could not be matched because the source documents used different identification numbers. Specifically, the Form 6248 information returns identified taxpayers by social security number, whereas the Form 720 excise tax returns were filed under an employer identification number. However, IRS pursued other approaches to determine if the 12,000 underwithheld producers filed annual returns for 1980. In March 1982, for instance, various service centers corresponded with these producers on this matter. Leads unresolved by the service centers were transferred to district offices for direct assignment to revenue officers. In the Southwest region,

these leads resulted in the securing of 1,410 delinquent returns, representing about \$1.05 million in delinquent windfall profit taxes.

Similarly, under this returns compliance program for tax year 1981, the Southwest region's revenue officers secured 747 delinquent returns, representing \$816,000 in delinquent windfall profit taxes. IRS officials informed us that this returns compliance program for tax year 1982 would begin in May 1984.

Incomplete and inaccurate information returns hampered IRS enforcement efforts

As stated earlier, IRS' ability to structure effective compliance programs for identifying delinquent windfall profit taxpayers depends largely on the availability, completeness, and accuracy of annual information returns. Service officials consider Form 6248 information returns essential to enforcing the windfall profit tax with respect to individual producers. Yet many thousands of the information returns received by IRS for calendar year 1980 were substantially incomplete, lacked taxpayer identification numbers, or contained inaccurate data. The Service must try to resolve these three types of deficiencies. Complete statistics for more recent years were not available at the time of our review, but IRS officials acknowledged that annual information returns continued to present problems.

The Internal Revenue Code has civil penalty provisions applicable to returns which are substantially incomplete or lack identification numbers. Use of these penalties may promote better compliance. Inaccurate information returns, however, are more difficult to detect and correct. The Service may need to focus more examination effort in this area.

Many information returns have been substantially incomplete or have lacked taxpayer identification numbers

Many of the 2.56 million windfall profit tax information returns received by IRS for calendar year 1980 were incomplete. For instance, about 20,000 returns could not be processed because filers used a nonstandardized format, or returns lacked pertinent information (e.g., amount of windfall profit tax liability). Generally, IRS considers such returns as being substantially incomplete. Some 243,000 others could not be processed due to lack of taxpayer identification numbers. More recently, for calendar year 1982, about 300,000 information returns received by IRS had no taxpayer identification numbers.

For taxes other than on windfall profits, IRS has recognized that failure to file penalties may be extended to information returns which are not substantially complete. For instance, in General Counsel Memorandum 36506, dated December 8, 1975, regarding annual information returns filed by tax-exempt organizations, IRS concluded that the filing of an incomplete return constitutes "failure to file a return" when reasonable cause cannot be shown and the missing information would hinder the Service from performing the duties and responsibilities placed on it by Congress.

In the memorandum, IRS' General Counsel emphasized the importance of certain information returns to the Service in administering revenue laws by drawing a distinction between missing information on tax returns and incomplete information returns:

"The purpose of a tax return is to report the information necessary to establish tax liability. The purpose of information returns, such as those under consideration in this case, is to provide information necessary for the Service to properly administer the revenue laws. Accordingly, there may be items required on a tax return that, if left blank, would not affect the determination of tax liability regardless of its completeness. On the other hand, if material information requested on an information return is not supplied, the Service will not be able to perform the duties and responsibilities placed upon it by Congress."

Service officials think the same reasoning applies to incomplete Form 6248 information returns. Furthermore, another section of the Internal Revenue Code--section 6676--prescribes a penalty for not providing a taxpayer identification number on a return. As mentioned above, some 243,000 windfall profit tax information returns filed for 1980 and about 300,000 filed for 1982 had no taxpayer identification number. According to IRS officials, the section 6676 penalty for failing to provide taxpayer identification numbers is applicable to Form 6248 information returns. Moreover, the Tax Equity and Fiscal Responsibility Act of 1982 increased the civil penalty for failure to supply identifying numbers from \$5 to \$50 per offense but not to exceed \$50,000 for all such failures in any calendar year. Consequently, IRS now has an enhanced tool to help assure compliance with windfall profit tax reporting requirements.

Inaccurate information returns pose problems

According to IRS, in addition to information returns which had no taxpayer identification numbers or were otherwise incomplete, the Service has received many returns which are inaccurate in critical areas such as number of barrels of oil removed

and total windfall profit tax liability. IRS and oil industry officials have further acknowledged that many of the Form 6248 information returns for tax year 1980 have been amended as many as four or five times.

These inaccuracies and amendments resulted in part from the oil industry's inexperience with the complex new tax. Also, longstanding accounting problems within the oil and gas industry contributed to these problems. For example, a very high percentage of payment checks to oil interest owners need to be adjusted in succeeding months. Such adjustments are needed for a variety of reasons--price corrections, state severance tax changes, ownership changes, miscellaneous corrections, etc.--and may pertain to a period of time ranging back from 1 month to several years. These longstanding accounting problems have been exacerbated by the greatly increased flow of information among purchasers, operators, and producers for windfall profit tax purposes.

According to IRS officials, inaccurate information returns continued to pose problems for 1981 and 1982 filings. However, Examination Division revenue agents have been able to correct some annual information returns during first purchaser examinations. Pursuant to IRS' interim audit guidelines, some examiners are comparing or reconciling the withholding agent's quarterly excise tax returns (Forms 720) for the year with the total of all applicable producers' annual liability as shown on annual information returns (Forms 6248). This is usually done by IRS computer audit specialists who run a test program on the company's automated records system. By performing the reconciliation for a sample number of producers, the test program can identify systemic problems with the withholding agent's computer operation.

In some cases, this technique has enabled examiners to identify inaccurate information returns and to have the company issue corrected returns. In other cases, this technique may not be successful, due to records availability problems or other difficulties. Still, however, where possible to apply, this audit technique or matching exercise is warranted in terms of the potential it offers for identifying systemic withholding problems.

CRIMINAL INVESTIGATION DIVISION ACTIVITIES

As of January 1983, the Service's cumulative inventory of windfall profit tax cases handled by the Criminal Investigation Division was only eight cases--all within the Southwest region. We were unable to update the inventory to 1984. However, an IRS official informed us that, as of February 15, 1984, the Service

had not referred any windfall profit tax cases to the Department of Justice for criminal prosecution. In one respect, the Service's small inventory of criminal investigations is a function of the difficulties encountered by the Examination Division, a traditional source of referrals. Until effective examination approaches are developed for issues such as oil exchanges, the volume of examination referrals is not likely to increase significantly. Therefore, to establish a broader Criminal Investigation Division presence in the windfall program, the Division needs to begin some self-initiated information gathering efforts.

The Criminal Investigation Division's cases are based on referrals

IRS' Criminal Investigation Division is responsible for investigating criminal violations of the tax laws. The existing criminal sanctions in the Internal Revenue Code apply also to the windfall profit tax. Section 7201, for example, covers attempts to evade or defeat tax, and section 7202 addresses willful failure to collect or pay over tax. In addition, a specific windfall criminal law provision was added by the 1980 Windfall Act--section 7241--which deals with "willful failure to furnish certain information regarding windfall profit tax on domestic crude oil." Such failure is a misdemeanor and carries a maximum \$10,000 fine and/or 1 year imprisonment.

In developing criminal tax cases, district office special agents investigate and evaluate information from three basic sources: (1) referrals from IRS' Examination and Collection Divisions, (2) self-initiated information gathering efforts, and (3) information items received from the public and other sources. However, it is the first source, referrals, from which many cases are developed. As discussed in a prior GAO report, traditionally about 50 percent of the Criminal Investigation Division's cases are initiated from referrals.³ The reason for this is that examination and collection agents deal directly with taxpayers and often are the first to spot potential tax fraud.

In the windfall profit tax program, the total inventory (eight cases) of criminal investigations as of January 1983 had been based on referrals--seven from the Examination Division and one from the Collection Division. All of these referrals were within IRS' Southwest region. The results of these referrals, as of January 1983, can be summarized as follows:

³Improved Planning for Developing and Selecting IRS Criminal Tax Cases Can Strengthen Enforcement of Federal Tax Laws
(GAO/GGD-80-9, Nov. 6, 1979).

--The Criminal Investigation Division decided not to investigate three of the referrals for various reasons, such as an absence of recoverable revenue or lack of sufficient evidence.

--Special agents had finished investigating three other referrals. Two of these investigations were completed without a recommendation for prosecution because criminal intent could not be proven. The prosecution potential of the other completed investigation was still being considered as of January 1983; there was a difference of opinion between the district and regional offices involved.

--The Division's special agents were still investigating two other referred cases.

One reason for the lack of self-initiated information gathering efforts in the windfall profit tax program is the fact that the Criminal Investigation Division initially concentrated on developing criminal investigation guidelines for the tax. The guidelines were to serve as a tool to assist IRS employees in recognizing potential areas of windfall profit tax fraud involving producers, operators, and/or purchasers, and other withholding agents. The guidelines, developed largely by the Southwest region, were issued in July 1982 to all Criminal Investigation Division special agents, Examination Division revenue agents, and Collection Division revenue officers involved in windfall profit tax activities.

The purpose of the windfall profit tax criminal investigation guidelines is expressed in the document partially as follows:

"Without question, the large sums of money provide great incentive to cheat. Therefore, for Criminal Investigation to properly exercise its responsibility for enforcement of criminal sections of the Internal Revenue Code, immediate attention to this new law is necessary. It is therefore the express intent of this document to encourage WPT [windfall profit tax] referrals by [Examination Division] revenue agents and to assist [Criminal Investigation Division] special agents when they conduct their investigations. . .

"Special agents can also use these guidelines for ideas to be used in information gathering aimed at WPT [windfall profit tax] violators."⁴

As presented, the guidelines recognized the need to establish an immediate presence. To accomplish this, the guidelines gave priority to referrals while also mentioning the feasibility of information gathering.

The Division needs to begin
information gathering efforts

As of February 1984, the Criminal Investigation Division had not begun any self-initiated information gathering efforts in the windfall profit tax program. In the 1979 report mentioned earlier (GAO/GGD-80-9), we discussed the importance of such efforts in reference to IRS' general overall procedures for developing and selecting criminal cases. The report stated that, to successfully carry out its mission, the Criminal Investigation Division must actively seek out and identify pockets of noncompliance with the tax laws. To this end, the report noted that special agents may be authorized to initiate efforts designed to determine whether a particular individual, business, or group has violated those laws. Such efforts are referred to as "individual information gatherings" and "information gathering projects."

The Chief of the Criminal Investigation Division at the district can approve an information gathering effort directed at a given individual. Each effort is directed toward gathering information on a specific taxpayer who is or appears to be involved in possible tax fraud. On the other hand, district directors or higher level IRS officials must approve projects directed toward gathering information on a group of taxpayers within such categories as an occupation, an industry, or a geographical area. Some projects, such as those directed at narcotics traffickers and filers of multiple false tax returns, are nationwide in scope. Other projects are regionwide; most, though, are initiated and carried out at the district level.

One windfall profit tax area where a self-initiated information gathering project might be particularly fruitful is multiple transaction oil. As discussed earlier, this area presented problems to the Department of Energy and is now presenting examination challenges for IRS. Drawing upon the Examination Division's experience, or working jointly, it may be appropriate

⁴Department of the Treasury, IRS, Windfall Profit Tax: Examination and Discussion of Possible Criminal Violations, Document 6764 (6-82), pp. 1-2.

for the Criminal Investigation Division to become involved in an information gathering project regarding multiple exchanges of oil. Other issue areas which seem to warrant consideration for information gathering projects are stripper oil and tank bottom oil (see chapter 4).

To better enable district directors and higher level IRS officials to evaluate the appropriateness of proposed information gathering projects, the GAO 1979 report cited above recommended that project justification statements discuss factors such as "(1) purpose and scope of the proposed effort, (2) methodology CID [Criminal Investigation Division] plans to follow, (3) risks involved, and (4) relationship of the project to national, regional, and district CID [Criminal Investigation Division] program goals." We still support this recommendation and, in our opinion, the Division's goals should include some self-initiated information gathering projects in the windfall profit tax program. By undertaking such projects, the Criminal Investigation Division would provide additional assurance that IRS has a full complement of integrated enforcement efforts for the windfall profit tax.

CONCLUSIONS

With passage of the Crude Oil Windfall Profit Tax Act in April 1980, IRS sought to quickly develop and implement an overall compliance enforcement program. In that regard, IRS extended its examination, collection, and criminal investigation programs to the windfall profit tax.

Although the Service has made good progress, much remains to be done. IRS needs to (1) develop an effective means for identifying and selecting oil property operators for examination, (2) assure that the windfall profit tax is assessed and paid on oil involved in multiple transactions, (3) establish effective, uniform procedures for conducting net income limitation examinations, and (4) determine whether and how to correct tax liabilities of producers who erroneously deducted non-qualifying state severance taxes in computing the windfall profit tax.

The first and second problems can perhaps be remedied through implementation of new requirements for the filing of an information tax return and the use of a "tax paid" certificate (or similar document), respectively. There are paperwork and cost considerations involved in assessing the feasibility of those approaches, however. In any case, actions directed at resolving those problems are needed.

The net income limitation problem is even more complex. Net income limitation claims can involve billions of dollars, and an effective, coordinated examination approach is needed.

Developing such an approach will necessarily involve striking a proper balance between equally legitimate IRS and taxpayer concerns. IRS needs to decide on an approach, communicate its decision to examiners and taxpayers, and then follow up on that decision.

The state severance tax problem involves determining the potential costs and benefits that would be associated with seeking to compute, assess, and collect additional taxes due from producers in the various states where nonqualifying severance taxes were used in computing windfall profit tax liabilities. IRS needs to determine whether it would be feasible and desirable to pursue compliance efforts in this area and, if so, to develop the necessary procedures.

IRS' Collection Division, which is responsible for collecting delinquent taxes, early extended its traditional compliance activities to the windfall profit tax program, particularly use of the federal tax deposit alert system. However, nonfiled, incomplete, and inaccurate information returns have hindered the effectiveness of specially developed returns compliance programs.

The Form 6248 annual information return is IRS' major compliance document in the windfall profit tax program. Before enactment of the Technical Corrections Act in January 1983, however, there was no civil penalty that could be imposed on withholding agents for failure to file. IRS officials believe the absence of a penalty resulted in the nonfiling of many information returns. Enactment of the penalty provision should help improve compliance in this area, not only by helping to assure that information returns are filed but also by helping to assure that the returns are prepared with some degree of completeness.

Furthermore, another law, the Tax Equity and Fiscal Responsibility Act of 1982, provides IRS another enhanced tool to help assure compliance with windfall profit tax reporting requirements. That is, the act increased the civil penalty for failure to provide taxpayer identification numbers on returns. For 1980, this kind of data was missing on over 200,000 windfall profit tax information returns filed with IRS.

Penalties for nonfiling and incompleteness will not alleviate all the problems associated with the reliability of annual information data. Many inaccurate windfall profit tax information returns have been filed, partly because of the oil industry's inexperience with the complex new tax. Oil companies are also having difficulty reconciling their accounts with intermediate disburers in a manner which will allow them to file accurate and timely annual information returns.

Revenue agents have been able to identify and correct some inaccurate Form 6248 information returns during first purchaser examinations by comparing or reconciling the entity's information returns with the quarterly excise tax Forms 720. While the recordkeeping or accounting problems experienced by withholding agents may limit the effectiveness of such comparisons, the audit practice is still useful for identifying systemic withholding problems. However, the Service's audit guidelines do not specifically direct revenue agents to verify the reliability of Forms 6248 information returns.

As of January 1983, the total cumulative inventory of windfall profit tax cases handled by the Criminal Investigation Division was eight--all of which had been referred by other IRS divisions. This limited activity is largely a function of the difficulties encountered by the Examination Division because, traditionally, much of the Criminal Investigation Division's workload has been initiated as a result of referrals from that Division. To establish a broader Criminal Investigation Division presence in the windfall program, the Division needs to begin some self-initiated information gathering efforts.

RECOMMENDATIONS

So that IRS can further enhance its windfall profit tax examination program, we recommend that the Commissioner of Internal Revenue

- develop and implement a more effective means for selecting oil property operators for examination. One means for accomplishing that objective would entail requiring operators to submit annual information returns to IRS. This, of course, would require issuance of Treasury Department regulations. The returns could contain property-by-property data on such items as oil production volume, oil tiers, base prices, and state severance taxes. IRS could use such information as a basis for developing an effective operator examination selection approach. In considering this option, however, the increased paperwork burden on and costs to the oil industry should be taken into account.
- develop and implement an effective means for assuring that the windfall profit tax is assessed and paid on oil involved in multiple transactions. In this regard, requiring the use of a "tax paid" certificate or similar document throughout the oil production and marketing process may be an effective means for resolving this problem. Again, however, the increased paperwork burden on and costs to the oil industry need to be taken into account. Regardless, we think the issue is sufficiently significant for IRS to evaluate the need for such a certificate. If such a certificate is deemed necessary and

appropriate, either Treasury regulations should be promulgated or, if needed, legislation should be sought.

--develop effective, coordinated procedures for examining net income limitation claims and adjustments. Because this provision of the Crude Oil Windfall Profit Tax Act involves billions of dollars in refunds, considerable attention should be devoted to developing effective examination procedures. Effective cross-district and cross-tax-year coordination will be required to (1) assess dispersed windfall profit tax and income tax records and (2) avoid duplication of effort and its potential effects--inconsistencies of results, inequities to taxpayers, and strained IRS-taxpayer relations.

--analyze the windfall profit tax liability effects of IRS' May 1982 revenue rulings, which discuss the allowability of various states' severance taxes. The Service needs to decide whether adjustments to affected taxpayers' windfall profit tax liability can and should be made for past taxable periods.

The Service's ability to structure an effective windfall profit tax collection program depends largely on the availability, completeness, and accuracy of Forms 6248 annual information returns. Therefore, we recommend that the Commissioner of Internal Revenue require revenue agents to perform, where practical during first purchaser examinations, a reconciliation of the withholding agent's quarterly excise tax returns (Forms 720) for the year with the producers' windfall profit tax liability as shown on annual information returns (Forms 6248). In performing such reconciliations, examiners should particularly try to identify systemic problems with the withholding agents' computer operations.

To give the Criminal Investigation Division a broader presence in the windfall profit tax program, we recommend that the Commissioner of Internal Revenue have that Division begin some information gathering efforts. Potential targets which should be considered include multiple transaction oil, stripper oil, and tank bottom oil.⁵

AGENCY COMMENTS AND OUR EVALUATION

By letter dated August 26, 1983, the Commissioner of Internal Revenue, with a few exceptions, expressed basic agreement with our conclusions and recommendations. The Commissioner further stated that in response to our recommendations, IRS plans to

⁵Problems relating to stripper oil and tank bottom oil are discussed in chapter 4.

- review windfall profit tax regulations to determine if revision is needed to require operator data. Also, IRS will pursue a series of administrative initiatives aimed at gathering additional information on oil property operators.
- propose legislation which would amend Chapter 45 of the Internal Revenue Code to empower IRS with the right of requiring evidence (such as a "tax paid" certificate) that the correct amount of windfall profit tax has been withheld or otherwise paid. The certification would "follow the oil" and would incorporate data reflecting the property from which the oil was removed; the removal price, type, tier, and gravity of the oil; and the amount of windfall profit tax withheld or deposited.
- develop additional guidance for examining net income limitation claims and adjustments. This guidance will be included in IRS' Techniques Handbook for Specialized Industries - Oil and Gas. Furthermore, IRS plans to determine whether there is a need for a legislative proposal with respect to certain net income limitation claims.
- formalize interim instructions to provide that any examination of a first purchaser or qualified disburser include a reconciliation of the withholding agent's quarterly excise tax returns (Forms 720) for the year with the producers' windfall profit tax liability as shown on annual information returns (Forms 6248). The instructions will be contained in IRS' Techniques Handbook for Specialized Industries - Oil and Gas. In addition, IRS is considering the possibility of moving windfall profit tax reporting to a separate return, which would enhance the capabilities of the Service to verify, check, and cross check windfall profit tax withholding.

Regarding our recommendation that IRS analyze the windfall profit tax liability effects of the Service's May 1982 revenue rulings, which discuss the allowability of various states' severance taxes, the Commissioner stated that IRS does not plan to establish a separate examination classification and selection program. However, the rulings have been made available to all regional windfall profit tax coordinators and all agents working windfall profit tax cases. Any taxpayer's examination thus will include the severance tax issue--an approach which appears reasonable given limitations on IRS' resources. Regarding our recommendation that IRS' Criminal Investigation Division conduct information gathering projects in the windfall profit tax program, the Commissioner agreed to consider the feasibility of such projects. We continue to believe that there is a need for positive action in this regard. Appendix I contains a copy of the Commissioner's comments.

CHAPTER 4

PROGRESS HAS BEEN MADE TOWARD RESOLVING SOME WINDFALL PROFIT TAX DEFINITIONAL ISSUES, BUT PROBLEMS CONTINUE

As discussed in chapter 1, the Crude Oil Windfall Profit Tax Act of 1980 is an extremely complex law. In seeking to administer the law, Treasury and IRS have faced complex issues relating to all aspects of the oil production process--from reservoirs and properties to pipelines and certain liquid hydrocarbons (condensate) recovered from natural gas by surface separators and even to seemingly innocuous issues such as the taxability of crude oil reclaimed from the sludge in storage tank bottoms. Generally, these issues have involved the definitions of basic terms necessary for calculating the windfall profit tax. These definitional issues have focused on such threshold terms as "property," "stripper well property," and even "crude oil" itself. Some aspects of these issues have been resolved, but additional guidance on other aspects is needed. Specific accomplishments, and further actions needed, include the following.

Property is the concept which establishes the applicable windfall profit tax rate from a range of 25 to 70 percent. As such, the property concept is the cornerstone of the windfall profit tax. Property is defined as "the right to produce domestic crude oil"--as that right existed in 1972, the year before energy price controls began. Because property is defined with respect to a specific base year--1972--subsequent transfers, segregations, or aggregations of land generally do not create new properties. In response to a previous GAO recommendation, Treasury issued temporary regulations in November 1982 to clarify the property concept. IRS then gave priority to closing out, in a consistent manner, all the windfall profit tax examinations previously held in suspense due to property definition uncertainties.

Stripper oil has also presented IRS some definitional problems. About one-eighth of the oil produced in the United States is stripper oil. Stripper oil is oil from a "stripper well property." Generally, this means crude oil from a property whose average production per well does not exceed 10 barrels per day. However, the issue of whether injection wells can be included in the well count used to determine stripper property status has been controversial and involves millions of dollars. An injection well is a well used to input water or gas into an oil-producing underground formation to maintain or increase the pressure which forces oil to the surface. Counting injection wells in the well count used to determine stripper property status increases the opportunity to obtain such favorable

status. Stripper oil was accorded preferential treatment during the period of energy price controls. Similarly, obtaining stripper well property status has advantages for windfall profit tax purposes; for example, independent producers were exempted from windfall tax on stripper oil beginning January 1, 1983.

A federal court of appeals recently decided that injection wells could not be included in the well count used to make stripper property determinations. That decision was for energy price control purposes but may have also resolved the injection well issue for windfall profit tax purposes. Further, on January 20, 1983, IRS issued proposed regulations dealing with the definition of oil from a stripper well property and the exemption for independent producers. These regulations specify that injection wells are not included in the well count. The proposed regulations also provide guidance on how the rule of "once a stripper, always a stripper" and other Department of Energy rules apply in determining independent producers' qualification for the stripper well exemption. However, this latter aspect of the proposed regulations has generated considerable controversy. Industry representatives assert that the regulations, by denying stripper status to certain oil properties, conflict with congressional intent. Industry representatives contend that the rule of "once a stripper, always a stripper" was not intended to be modified.

Whether taxable "crude oil" included condensate also arose as an issue soon after passage of the Crude Oil Windfall Profit Tax Act. Generally, condensate refers to the liquid hydrocarbons recovered from natural gas by surface separators. About 149 million barrels of condensate were produced domestically in 1981. In January 1983, the Congress enacted the Technical Corrections Act of 1982 to remove any doubt that condensate from both oil and gas wells is taxable. Now that the issue of the taxability of condensate has been settled, Treasury and IRS are developing regulations to provide the public with guidance on this matter and to help assure that the tax is assessed and collected.

Another aspect of taxable "crude oil" is how the windfall profit tax ought to be assessed and collected on crude oil reclaimed from the sludge (basic sediment and water) in storage tank bottoms. Comprehensive statistics on the volume of reclaimed crude oil are not readily obtainable. However, a regulatory agency official in Oklahoma estimated that the approximately 75 plants in the state separate a total of about 40,000 to 50,000 barrels of crude oil a month from basic sediment and water. In any event, IRS still needs to take action to minimize the revenue loss possibilities and the tax evasion opportunities presented by such oil. As of October 1983, the Service had not issued any regulations or revenue rulings dealing with windfall profit tax requirements for tank bottom oil.

Each of these issues is discussed in detail below.

GAO'S RECOMMENDATION THAT THE
PROPERTY CONCEPT BE CLARIFIED
HAS BEEN IMPLEMENTED BY TREASURY

The basic determinant of the windfall profit tax rate is property, a concept which the act incorporates by reference to Department of Energy regulations. Thus, property has the same meaning for windfall profit tax purposes as it had for energy price control purposes. The property concept is singularly important because it controls the category or tier of crude oil which, in turn, establishes the applicable windfall profit tax rate from a range of 25 percent to 70 percent.

Property is defined as "the right to produce domestic crude oil"--as that right existed in the year before energy price controls began. Because property is defined with respect to a specific base year--1972--subsequent transfers, segregations, or aggregations of land generally do not create new properties. Further, the property concept, which arises from the right to produce, is not flexible and does not change with the substitution of one lessee for another. For example, a 1,000-acre tract of land, owned or leased by one person, which produced oil in 1972, may have been subdivided into two 500-acre parcels and sold or leased to new parties after 1972. Those transfers have no effect on the definition of the property. There is still only one property--the 1,000-acre land tract--because that tract equates to the right to produce oil as it existed in 1972. The new parties merely obtain portions of the basic or integral right to produce. Post-1972 subdivisions generally do not create new properties. If such subdivisions had been permitted, taxpayers could reduce the windfall profit tax rate on their oil by as much as 45 percent simply by changing the tier classification of that oil (see app. IV and table 8 in app. III).

Our early work found that considerable uncertainty surrounded the property concept within IRS. Our work in IRS' Southwest region, the lead and most active IRS region in the windfall profit tax program, showed that property issues were treated inconsistently and inaccurately during initial IRS examinations of oil well operators. As a result, examiners sometimes were not making correct property determinations and thus were not accurately verifying reported windfall profit tax liabilities.

We discussed our findings with representatives from IRS' Southwest regional office. To the extent possible, the region took quick corrective action at the local level, which included suspending the closure of cases with property issues until more definitive guidance could be developed. Later, IRS' national office extended the case closure suspension to the Service's other regions and brought the property issue to the Treasury Department's attention. As of July 31, 1982, IRS estimated that about 3,700 examination cases had been placed in a suspense status pending resolution of the property issue.

The property issue is discussed in our May 13, 1982, report to the Secretary of the Treasury entitled Uncertainties about the Definition and Scope of the Property Concept May Reduce Windfall Profit Tax Revenues (GAO/GGD-82-48). The report stated that, given the program-wide significance of the property concept and its pivotal role in determining windfall profit tax rates, Treasury and IRS needed to quickly develop and disseminate guidance on the basic definition of property and the appropriate examination approach. By doing so, Treasury and IRS would help assure establishment of a more effective compliance program. By letter dated April 29, 1982, in commenting on a draft of our report, the Treasury Department stated that a notice of proposed rulemaking concerning the property concept would be issued and that public comments on the proposal would be solicited before a final decision is made. Treasury further stated that it would make every effort to expedite the regulations project.

In September 1982, Treasury reached a decision regarding the definition of property for windfall profit tax purposes. Specifically, Treasury decided to adopt a "production rule." This means that, with respect to properties which were producing crude oil and/or natural gas on January 1, 1972, the boundaries are defined by reference to leases or fee interests in effect on that date. For properties not producing oil or gas on January 1, 1972, the boundaries are or will be defined through reference to leases in effect at the time of first production. Clarification of the property concept, in the form of temporary regulations, was issued on November 10, 1982. Accordingly, Treasury and IRS then took action to assure that windfall profit tax cases held in a suspense status were closed out consistent with the issued regulations. This was particularly important in light of the fact that the statute of limitations with respect to initial windfall profit tax returns expired in May 1983, unless extension agreements were obtained from the producer-taxpayers.

STRIPPER OIL ISSUES HAVE BEEN ADDRESSED BY THE COURTS AND IRS

The Crude Oil Windfall Profit Tax Act defines stripper oil as "any oil which is from a stripper well property within the meaning of the June 1979 energy regulations." In turn, the energy regulations define stripper oil as crude oil from a property whose average daily production per well does not exceed 10 barrels. Yet, until recently, the energy definition of stripper oil had long been a subject of controversy and court actions for price control purposes. Specifically at issue was whether injection wells should be included in the well count used to determine stripper status. A July 1982 court decision resolved this issue by finding that injection wells were not to be counted in making stripper property determinations.

Also, the Economic Recovery Tax Act exempted independent producers from windfall profit tax on stripper oil effective January 1, 1983. As a result, questions have arisen as to how certain Department of Energy rules ought to be applied for windfall profit tax purposes. Specifically, the questions concern two energy rules--the rule of "once a stripper, always a stripper" and the rule which permits a separate and distinct reservoir to be treated as a separate property. IRS has issued proposed regulations addressing these matters, but the regulations have generated substantial controversy.

The injection well issue
has been debated for many years

An injection well is a well used to input water or gas into an oil-producing underground formation to maintain or increase the pressure which forces oil to the surface. The issue of whether injection wells could be included in the well count used to determine stripper property status has been the subject of much litigation. Much of the injection well litigation was consolidated into one proceeding, the Energy Reserves Group case, with the plaintiff oil companies depositing a total of more than half a billion dollars into a court supervised escrow account. Generally, these funds represented the price advantage of counting injection wells--that is, the funds represented the price difference between old oil, which was price controlled, and stripper oil which could command market prices. In July 1982, an appeals court ruled on this issue for energy price control purposes, finding that injection wells were not to be counted in making stripper property determinations. Recently, in January 1983, the Supreme Court declined to accept the issue for further review. Thus, the issue is now resolved for energy price control purposes and may also be resolved for windfall profit tax purposes.

Before this judicial resolution, many oil companies contended that the energy definition of stripper oil was not correct for price control purposes and, therefore, also was inaccurate for windfall profit tax purposes. Basically, the companies contended that injection wells are included in the well count used to determine if a property's well production averaged 10 or fewer barrels a day. Counting injection wells meant that certain crude oil production otherwise classified as old oil would qualify for stripper oil classification, and thus would be free from energy price controls and also have a lower windfall profit tax rate.

As mentioned, what constitutes a stripper property for purposes of the energy regulations was at issue for several years--at least since December 24, 1974, when the Federal Energy Administration issued Ruling 1974-29, interpreting the stripper

well exemption provided by section 406 of the Trans-Alaska Pipeline Authorization Act (P.L. 93-153, Nov. 16, 1973). That Ruling held that injection wells were not to be counted as wells for purposes of determining whether the average daily production per well from a property exceeded 10 barrels.

Industry challenged the Ruling. Cases filed by plaintiff oil companies were consolidated into one action for decision by the U.S. District Court of Kansas. In Energy Reserves Group, Inc. v. Federal Energy Administration,¹ the federal district court held that Ruling 1974-29, excluding the count of injection wells, was legislative in nature rather than interpretive of the regulation, and was therefore void.

The government appealed to the Temporary Emergency Court of Appeals, which reversed the lower court's decision. This decision, reported as Energy Reserves Group, Inc. v. Department of Energy,² held that Ruling 1974-29 was valid as a reasonable interpretation of the regulation implementing the statutory stripper well exemption. However, the appellate court sent back for district court trial the issue of whether the regulation correctly interpreted the intent of Congress and the issue of whether the regulation was arbitrarily and capriciously adopted by the Department of Energy.

By this time, much additional litigation on these same issues had begun in other federal court districts. These cases were subsequently forwarded to the Kansas district court for consolidation and disposition. On July 14, 1981, the federal district court in Kansas concluded that Congress intended injection wells to be included in the well count and, even if the statute did not mandate including injection wells, the manner in which the Department of Energy excluded injection wells from the well count was arbitrary and capricious. This decision is reported in In Re: The Department of Energy Stripper Well Exemption Litigation.³

The Department of Energy appealed to the Temporary Emergency Court of Appeals, which heard arguments on April 9, 1982. The appeals court ruled in the Department's favor on July 29, 1982, by concluding that injection wells were not to be counted in making stripper property determinations. However, in October 1982, industry appealed to the Supreme Court for a review of that decision. On January 10, 1983, the Supreme Court declined accepting the issue for further review. Thus, the controversy

¹477 F. Supp. 1135 (D. Kan. 1978).

²589 F. 2d 1082 (TECA 1978).

³520 F. Supp. 1232 (D. Kan. 1981).

over the injection well issue is resolved for energy price control purposes. Because the Crude Oil Windfall Profit Tax Act incorporates energy regulations, the injection well issue may also be resolved for windfall profit tax purposes. On January 20, 1983, IRS issued proposed regulations dealing with the definition of oil from a stripper well property; these regulations specify that injection wells cannot be included in the well count. Given the recent court decision on this issue, IRS' regulations may not encounter litigative obstacles similar to those encountered by the Department of Energy.

That the injection well issue may finally be resolved is important because the term "stripper well property" must be clearly defined for windfall profit tax purposes. The temporary nature of the windfall profit tax program and the large sums of money at stake necessitate a clear definition of stripper oil, particularly in light of the fact that stripper oil owned by independent producers was exempted from tax beginning January 1, 1983.

IRS has issued
proposed regulations
for exempt stripper oil

As previously discussed, the Economic Recovery Tax Act afforded independent producers an exemption from windfall profit tax on stripper oil beginning in 1983. That legislative change, coupled with two Department of Energy regulatory rules which apply for windfall profit tax purposes, could cause confusion over the tier category of certain oil by adding another element of complexity to the property concept discussed earlier in this chapter. One of the energy rules is "once a stripper, always a stripper." The other rule provides operators with the option to treat a separate and distinct reservoir as a separate property. Because a variety of producers (independents, integrated companies, and royalty owners) generally hold interests in a single property, it seems apparent that there will be conflicting oil tier considerations in situations where a separate and distinct reservoir is discovered on an established stripper property. In recently issued proposed regulations, IRS has specified how the two Department of Energy rules apply for windfall profit tax purposes in such situations. But the regulations have generated substantial controversy.

When enacted in April 1980, the Windfall Profit Tax Act provided that independent producers would be taxed at a 50-percent rate for old oil and a 30-percent rate for both stripper oil and newly discovered oil. Subsequently, however, the Economic Recovery Tax Act of 1981 changed windfall profit tax rates for stripper oil and newly discovered oil. Beginning in 1983, independent producers' stripper oil is exempt from the tax. During 1982 to 1986, the tax rate applicable to all owners of newly discovered oil will gradually be reduced annually until it reaches 15 percent.

The tax rate changes authorized by the Economic Recovery Tax Act were designed to further encourage oil exploration and production. However, the act has had the unintended effect of creating the potential for confusion over the tier category of certain oil. That is, problems can be expected to surface in those instances where drilling leads to the discovery of a separate and distinct oil reservoir on an established stripper property.

For example, if an operator drills and discovers a separate oil reservoir on a stripper property in 1983, the production from this reservoir could be considered stripper oil in accordance with the rule of "once a stripper, always a stripper." The regulatory rule of "once a stripper, always a stripper" was established by the Department of Energy during the period of crude oil price controls. The rule was established to encourage stripper property owners to maintain or increase production from marginally producing wells and to drill additional wells. Under this rule, for example, the owners of a low-producing well could have the well bore reworked to increase oil flow, without the consequent adverse economic effect of having the incremental production result in the loss of stripper oil status. Similarly, additional drilling on the stripper property which resulted in production from a separate reservoir, no matter how voluminous, would not affect the property's stripper status. Both the original stripper oil and the other reservoir's production would be free from price controls under the rule of "once a stripper, always a stripper." This was particularly significant during the period of price controls because stripper oil was priced as much as 200 percent higher than old oil.

On the other hand, if another Department of Energy rule--separate property election--is followed, the production from a stripper property reservoir, which is separate and distinct from and not contiguous with any other reservoir on the property, could be classified as newly discovered oil for windfall profit tax purposes. This is because the separate and distinct reservoir can be treated as a separate property if the operator elects to do so. And, for windfall profit tax purposes, newly discovered oil is defined as oil from a property which had no production in 1978.

Before January 1, 1983, the two Department of Energy rules caused little conflict among producers for windfall profit tax purposes. Although independent producers, integrated oil companies, royalty owners, and other parties often owned interests in the same properties, an operator's decision as to which Department of Energy rule to follow uniformly affected all concerned parties. Thus, a stripper property operator generally chose to follow the separate property rule with respect to a new reservoir because the production could then be taxed as newly discovered oil, which had the lowest windfall profit tax rate for all producers.

Beginning January 1, 1983, however, the two Department of Energy rules presented conflicting considerations for different producers. That is, when a separate reservoir is discovered on an established stripper property, independent producers probably will want to follow the "once a stripper, always a stripper" rule so that their production will be exempt from tax. On the other hand, royalty owners and integrated oil companies probably will want the reservoir to be a separate property so that the oil will qualify as newly discovered oil. For these producer-taxpayers, the 25 percent windfall profit tax rate for 1983 on newly discovered oil (phasing down to 15 percent) is considerably less than the 60 percent rate on stripper oil.

IRS recognized this dilemma and on January 20, 1983, issued proposed regulations to provide guidance in situations wherein a new reservoir is put into production on a property previously qualified as a stripper well property. The supplementary text which accompanied the issuance stated that

"In such cases, the proposed regulations provide that if no new property election is made for the new reservoir, the property's status for future periods must be redetermined. In other words, the property must again qualify under the average daily production standard when the new reservoir is put into production. Failure to adopt such a rule will permit producers to transform newly discovered oil into [exempt] stripper well oil. A redetermination of stripper well property status for the previously developed reservoir may be avoided if an election is made to treat the reservoir as a separate property. This rule will be effective for taxable periods beginning on or after March 21, 1983."

Essentially then, IRS' proposed regulations modify the application of the "once a stripper, always a stripper" rule to separate reservoir oil. While the Secretary of the Treasury is authorized by the Windfall Profit Tax Act to modify Department of Energy regulations as necessary or appropriate for windfall profit tax purposes, industry representatives argue that the proposed regulations exceed the Secretary's authority. Basically, the industry representatives contend that the proposed regulations violate the intent of the Congress in passing the stripper oil exemption. This is a point of major controversy, with significant tax revenue and oil production ramifications. Recognizing this, IRS held a public hearing on the issue on April 27, 1983, and is still in the process of analyzing information obtained during the hearing.

CONDENSATE PRESENTS TAX
LIABILITY AND COLLECTION QUESTIONS

Liquid hydrocarbons, referred to as condensate, can be recovered from natural gas through use of a surface separator or compressor plant. Questions regarding the taxability of condensate are important because millions of barrels of condensate are produced annually in the United States. In 1981, for example, approximately 149 million barrels were produced. In May 1981, Treasury and IRS asked for public comment on the question of what changes ought to be made to Department of Energy regulations in order to facilitate compliance with the Windfall Profit Tax Act. In responding to that request, the oil industry raised two major issues with respect to condensate:

--First, did the Congress intend that condensate be treated as "crude oil" for windfall profit tax purposes?

--Second, even if condensate were intended to be taxed, how can the administrative difficulties associated with assessing and collecting the tax be overcome?

The Congress resolved the first issue through recent legislation making clear the intent to tax condensate. Treasury and IRS are now addressing the administrative problems associated with carrying out that intent.

The Congress has
specified that
condensate is taxable

The Crude Oil Windfall Profit Tax Act defines the term "crude oil" by reference to the June 1979 energy regulations. These regulations specify that

"'Crude oil' means a mixture of hydrocarbons that existed in liquid phase in underground reservoirs and remains liquid at atmospheric pressure after passing through surface separating facilities. 'Crude oil' includes condensate recovered in associated oil well or non-associated gas well production by mechanical separators, whether located on the lease, at central field facilities, or at the inlet side of a gas processing plant."

The legislative history also indicates that condensate, from both oil wells and gas wells, was to be included in the definition of crude oil. However, some industry representatives argued that condensate from a gas well was not taxable crude oil. Their argument was based on section 4991(a) of the Internal Revenue Code which provides that the term "taxable

crude oil" means all domestic crude oil other than exempt oil. The term "domestic" is defined under section 4996(b)(3) of the code to mean crude oil produced from an oil well located in the United States or a possession of the United States. Consequently, some industry representatives argued that condensate from a gas well is not subject to windfall profit tax.

To resolve this issue and other technical aspects of various tax laws, the Congress enacted the Technical Corrections Act of 1982. The Technical Corrections Act amended the definition of crude oil to remove any doubt that condensate from both oil and gas wells is taxable. Now that the issue of the taxability of condensate has been settled, Treasury and IRS are drafting regulations to provide guidance for assuring that the tax is assessed and collected.

Assessment and collection of the windfall profit tax on condensate

Assuring assessment and collection of the windfall profit tax is especially difficult when condensate is recovered after removal of the gas from the premises on which it is produced. Commonly, for example, a gas stream leaves the lease by pipeline under substantial pressure. While in transit to a gas processing plant, pressure is reduced, causing the gas to cool and liquid condensate to form. The condensate is recovered at various pipeline drip collection points or at the inlet side of the gas processing plant.

In these situations, identifying producers and calculating and assessing the tax is often very difficult. To explain, producers and operators generally are paid for a gas stream based on its heating quality, with the price expressed in dollars or cents per thousand cubic feet, not in dollars per barrel. Also, condensate which accumulates during transit may belong by agreement either to the pipeline company or to the processing plant, neither of which is the producer-taxpayer for windfall profit tax purposes. The situation is further complicated when feeder lines result in commingled gas transmission and condensate is not readily attributable to certain leases or producers.

These difficulties present Treasury and IRS with the challenging task of developing an effective framework for assuring assessment and collection of the windfall profit tax. Treasury and IRS are analyzing these difficulties with a view toward developing regulations which will clearly fix the responsibility for assessing and collecting the tax under a variety of circumstances, e.g., when condensate is recovered on the lease, at drip collection points, at the inlet side of a plant, etc.

RECLAIMED TANK BOTTOM OIL
PRESENTS REVENUE LOSS POSSIBILITIES
AND TAX EVASION OPPORTUNITIES

Oil storage tank cleaners periodically remove from the tanks a substance known as basic sediment and water and then transport the substance to a treating facility where the oil content can be extracted for sale to a refinery. Crude oil recovered in this manner is not exempt from the windfall profit tax. Often, however, no tax may be due on tank bottom oil transactions because they do not generate a windfall profit at current prices. This could change if oil prices rise. Out of concern about imposing a potentially unnecessary paperwork burden, IRS has not specified that tank cleaners must file windfall profit tax returns. This situation, however, has created some revenue loss possibilities and tax evasion opportunities. Treasury and IRS need to take action to foreclose those opportunities. This perhaps can be accomplished without placing an unwarranted burden on tank cleaners.

Tank bottom oil is
not exempt from tax

Lease operators often collect and temporarily store oil in tanks before selling the oil. This storage causes a small percentage of oil which is emulsified with water to settle to the tank bottom. This substance is more commonly known as basic sediment and water and is not marketable in this emulsified state. When basic sediment and water accumulates up to the level of the tank cut-off valve, it must be removed from the tank to avoid contaminating the clean oil. Oil purchasing companies monitor tank bottoms, and when the basic sediment and water reaches a critical level, the lease operator must correct the problem. Generally, this is done by contracting the services of a tank cleaning company to remove the basic sediment and water.

Although basic sediment and water is not marketable as crude oil, its crude oil content can be reclaimed and sold to refineries. The oil is separated from the emulsion through treatment with heat and chemicals. Tank cleaners typically sell basic sediment and water to treating companies which are capable of reclaiming the oil. However, a large tank cleaning operation may have its own treating facility.

When oil prices were low in prior years, the lease operator would pay a tank cleaner to steam the tank and dispose of the basic sediment and water. As oil prices began to rise, many tank cleaners would perform their service for no pay except for the basic sediment and water. Today, some tank cleaners are actually paying the operator for the right to remove the tank

bottom. This price, of course, is far below the price of clean crude. But once the treater has separated the crude oil, the oil may be sold at or near the market value of clean oil.

Comprehensive statistics on the volume of such reclaimed oil are not readily obtainable but limited information indicate that the amount may be significant. Three of the leading oil producing states provided us information on the number of reclamation plants located within their states. These three states--Texas, Louisiana, and Oklahoma--have about 177 reclamation plants that separate oil from basic sediment and water. Only one of these states, Oklahoma, had readily available information on the approximate volume of oil reclaimed by reclamation facilities. A regulatory agency official estimated that the approximately 75 plants in Oklahoma collectively separate a total of about 40,000 to 50,000 barrels of crude oil a month from basic sediment and water. The Oklahoma official also stated that, as of January 1983, the reclaimed oil was selling for about \$23 a barrel and that the state was collecting severance taxes on this oil.

According to the Crude Oil Windfall Profit Tax Act of 1980, taxable crude oil means all domestic crude oil other than oil which is specifically exempt. And, since reclaimed oil is not specifically exempt from the windfall profit tax, it qualifies as taxable crude oil.

Revenue loss possibilities and tax evasion opportunities

According to an IRS Technical Division representative, a tank cleaning company becomes a first purchaser for windfall profit tax purposes when it removes basic sediment and water from a lease operator's storage tank. As a first purchaser of crude oil, a tank cleaner would need to make all the necessary calculations for and file all the tax forms related to the windfall profit tax. However, the Technical Division has not issued any formal ruling on this for two reasons.

First, there is a concern that meeting the computation and filing requirements of the act would prove difficult for these small businesses, both administratively and economically. Second, at recent crude oil market prices, sales of basic sediment and water generally do not generate a windfall profit. This is because the per barrel removal price for crude oil contained in basic sediment and water normally is less than the adjusted base price of the oil. To illustrate, if a tank cleaner paid \$1,000 to a lease operator for 500 barrels of basic sediment and water containing 200 barrels of reclaimable oil, the removal price of the oil for windfall profit tax purposes could be \$5 per barrel, which is the selling price of the basic sediment and water divided by the number of barrels of reclaimed oil. (The removal price would be higher if the fair market

value of the tank cleaner's services is added to the \$1,000 payment, an addition which some IRS officials think is appropriate.) A removal price of only \$5 a barrel is too low to generate a windfall profit, as tables 4, 5, and 6 in appendix III show more explicitly.

However, should crude oil prices rise substantially in the future, removal prices associated with basic sediment and water surely will follow suit. At a certain point in time, then, sales of basic sediment and water could generate windfall profits and, unless the necessary computations are made, and the necessary tax forms filed, neither the first purchaser nor IRS will be in a position to determine when a tax liability has been generated.

Of more immediate concern, however, is the fact that the lack of windfall profit tax computations and return filings may present tax evasion opportunities. Some IRS officials think that the absence of windfall profit tax withholding on reclaimed oil provides an opportunity for certain lease operators to evade potentially large amounts of windfall profit tax. These officials believe that some lease operators could sell substantial amounts of clean oil as tank bottom crude. Further, revenue agents are concerned that some lease operators may form their own tank cleaning companies and clean tanks that do not need cleaning or leave substantial amounts of clean oil to be salvaged with the basic sediment and water.

Under the above circumstances, the tank cleaner could obtain some clean oil ready for marketing. For example, a lease operator might sell to its tank cleaning company 70 barrels of "tank bottom," consisting fraudulently of 40 barrels of clean oil in addition to 30 barrels of basic sediment and water, for a nominal price of \$5 per barrel. Here again, since this price is below the minimum adjusted base price for taxable crude, the 70 barrels do not generate a windfall profit tax liability. Nonetheless, the tank cleaner can immediately resell the 40 barrels of clean oil at the prevailing market price. Absent knowledge of the fraud, IRS would consider this resale transaction to involve a second rather than the first purchase of the oil, and no windfall profit tax would be paid on what otherwise should be taxable crude oil.

Treasury and IRS need to foreclose the revenue loss possibilities and tax evasion opportunities associated with tank bottom oil. This perhaps can best be accomplished by clearly defining the windfall profit tax withholding and filing requirements for all of the parties having an economic interest in tank bottom oil. In this regard, Treasury and IRS may wish to consider designating the reclaiming or treating facility as a "producer" for windfall profit tax purposes. The actual crude oil content of basic sediment and water is not known until it is

reclaimed by the treating facility. Then the reclaimed oil is generally sold to a refinery. Taxing reclaimed oil when it is sold by the treating facility to the refinery would utilize the normal withholding agent approach in crude oil sales. The refinery, as a first purchaser of crude oil, already has established administrative withholding procedures. Taxing the reclaimer and having the refinery withhold the tax would effectively eliminate any potential tax evasion problem. There would be no advantage for lease operators to divert oil into basic sediment and water sales.

Under this approach, the initial transaction between the lease operator and the tank cleaner would be considered simply a sale of basic sediment and water. The purchase of reclaimed oil by the refinery would be considered the first purchase of crude oil for windfall profit tax purposes. This position seems consistent with the known properties of basic sediment and water. In its emulsified state, basic sediment and water is not marketable as crude oil. An administrative problem with taxing the reclaimer is that oil tiers may not be readily determinable, especially if the treating facility commingles basic sediment and water from various tank storage areas. However, as discussed earlier in this chapter, IRS faces, and must resolve, a similar problem with respect to the taxation of condensate. Thus, this problem is not unique to tank bottom oil and must be addressed in any case.

Treasury and IRS may wish to consider the feasibility of the above described approach as a means for foreclosing revenue loss possibilities and tax evasion opportunities with respect to tank bottom oil.

CONCLUSIONS

In seeking to develop the framework for a windfall profit tax compliance program, Treasury and IRS have faced a variety of complex issues raised by all aspects of the oil production process. Generally, these issues have involved the definitions of threshold terms necessary for calculating the windfall profit tax--terms such as "property," "stripper well property," and even "crude oil" itself. By resolving most of these definitional issues, the Congress, Treasury, and IRS have made the windfall profit tax more administrable.

By publishing temporary regulations in November 1982, Treasury and IRS have helped resolve definitional problems surrounding the property concept. Thus, the examination cases which IRS had held in suspense pending that action could be closed out.

Also, some key issues relating to the definition of stripper well property have been resolved. The issue of whether injection wells can be included in the well count used to determine stripper property status was long a subject of controversy and court actions for energy price control purposes. A July 1982 decision by the Temporary Emergency Court of Appeals and a January 1983 determination by the Supreme Court to not review the lower court's decision have resolved this issue for energy price control purposes and may also have resolved the issue for windfall profit tax purposes.

Another stripper oil issue was raised by certain Department of Energy rules in conjunction with the Economic Recovery Tax Act of 1981, which granted independent producers an exemption from windfall profit tax on stripper oil beginning in 1983. That exemption, coupled with two Department of Energy rules--the rule of "once a stripper, always a stripper" and the rule which allows individual reservoirs to be treated as separate properties--could lead to conflicting oil tier considerations in situations where a separate and distinct oil reservoir is discovered on an established stripper property. Consequently, IRS issued proposed regulations on January 20, 1983, to specify how these rules apply for windfall profit tax purposes in such situations. These regulations, however, have generated substantial controversy. IRS conducted a public hearing on this issue on April 27, 1983, and is now in the process of evaluating the information provided during the hearing. As of February 15, 1984, however, final regulations had not been issued.

With the January 12, 1983, enactment of the Technical Corrections Act, the Congress resolved certain questions about the tax status of condensate. In light of that action, Treasury and IRS are developing regulatory guidance to assure collection of the windfall profit tax on condensate. However, as of February 15, 1984, the planned regulations had not been issued.

An aspect of the oil production process which needs more attention for windfall profit tax purposes is tank bottom oil, that is, oil which a treating facility extracts from the basic sediment and water removed from storage tanks. Treasury and IRS need to foreclose the revenue loss possibilities and tax evasion opportunities presented by such oil. Treasury and IRS can perhaps best accomplish this by defining the windfall profit tax withholding and filing requirements for all of the various parties having an economic interest in tank bottom oil.

RECOMMENDATION

With respect to tank bottom oil, we recommend that the Secretary of the Treasury develop and issue regulations directed at minimizing revenue loss possibilities and tax evasion opportunities. In so doing, the Secretary should consider the feasibility of taxing reclaimed oil when it is moved from the treating facility to the refinery. Such an approach seemingly would foreclose the revenue loss possibilities and the tax evasion opportunities in this area.

AGENCY COMMENTS AND OUR EVALUATION

By letter dated August 26, 1983, the Assistant Secretary for Tax Policy, Department of the Treasury, and the Commissioner of Internal Revenue agreed that the issues relating to tank bottom oil should be addressed and anticipated that the necessary guidelines and rules would be issued in the not-too-distant future. Appendix I contains a copy of the Assistant Secretary's and the Commissioner's comments. Later, IRS officials informed us that a revenue ruling project was in process but, as of February 15, 1984, the ruling had not been finalized.

CHAPTER 5

OTHER ADMINISTRATIVE AND LEGISLATIVE ACTIONS

CAN BE TAKEN TO FURTHER FACILITATE

WINDFALL PROFIT TAX ADMINISTRATION

The administrative challenges presented Treasury and IRS by the substantive and procedural complexities of the Windfall Profit Tax Act are perhaps unprecedented. As discussed in chapter 4, Treasury and IRS have had to deal with a series of complex definitional issues related to the oil production process. Equally challenging, however, has been the task of adapting normal tax assessment and collection mechanisms to the crude oil tax. Although the complexity associated with the tax has created a series of problems, there are several means through which windfall profit tax administration can be facilitated. Specifically,

- Treasury and IRS can consider the feasibility of extending the time period during which withholding agents can adjust producers' tax liabilities and/or payments. This could result in a streamlining of the tax collection process and a reduction in paperwork for both IRS and taxpayers.
- the Congress can authorize IRS to issue statutory notices of deficiency on a property-by-property basis. This would reduce IRS' case control burden while also benefiting taxpayers.
- the Congress can further modify the laws governing judicial appeals so as to avoid duplicative court actions on identical issues arising from the same oil property. This would help avoid the development of a potentially heavy backlog of windfall profit tax cases in the Tax Court, while also preserving the appeal rights of taxpayers.

Besides the aforementioned steps, windfall profit tax administration also will be facilitated when IRS fully implements a computerized information system.

EXTENDING THE TIME PERIOD DURING WHICH WITHHOLDING ADJUSTMENTS CAN BE MADE COULD PROVE ADVANTAGEOUS

Current IRS regulations generally provide that purchasers and other withholding agents cannot make corrections of errors in producers' windfall profit tax liabilities and/or payments after the Annual Information Return of Windfall Profit Tax (Form

6248) is furnished to producers, which is March 31 of the year following the year the crude oil is removed from the premises. Producers use the information returns in completing their income tax returns because, as noted earlier, the windfall profit tax is deductible for income tax purposes. However, the limited time frame for withholding agents to make windfall profit tax adjustments results in many taxpayers being over- or underwithheld because, for various reasons, many withholding errors are not detected before the March 31 cut-off date. This, in turn, leads to the filing of many tax forms related to refund claims or supplementary windfall profit tax payments.

If withholding agents were permitted to make adjustments to producers' tax liabilities and/or payments, after distribution of the annual information returns, there could well be a very substantial decrease in windfall profit tax paperwork and a considerable decrease in IRS' returns processing workload. The benefits associated with reduced paperwork would also accrue to the many taxpayers who would no longer have to file certain tax returns and/or deal with amended returns.

IRS does have some concerns about the feasibility of extending the time period for making withholding adjustments. For example, IRS is concerned that the continuation of withholding adjustments after Form 6248 information returns have been furnished would create the likelihood of a double payment by the producer if the adjustment increased withholding, or a double refund if the adjustment decreased withholding. Nevertheless, if these concerns can be overcome, both IRS and taxpayers could benefit from a revised adjustment process. Given the numerous issues and problems facing IRS in the windfall profit tax program, the Service has been unable to spend a great deal of time researching this issue. Still, a thorough evaluation of this proposal is warranted.

Purchasers can correct some
withholding errors by making
adjustments to later payments

The windfall profit tax withholding system is susceptible to withholding errors because of the large volume of information flowing among operators, purchasers, and producers. Generally, purchasers correct withholding errors by adjusting later payments to the producer for crude oil removed during the same calendar year. If the full adjustment is not possible in the next payment, the purchaser generally adjusts each subsequent payment to the fullest extent possible until the withholding error is corrected.

IRS regulations, however, provide that purchasers cannot make corrections of errors in withholding after the Annual Information Return of Windfall Profit Tax (Form 6248) is furnished to producers, which is March 31 of the year following the year

the oil is removed from the premises. For example, for crude oil removed during calendar year 1980, the cut-off date for adjustments by first purchasers was March 31, 1981.

Typically, however, many withholding errors will not have been detected and corrected by the March 31 cut-off date. This is the case in part because there have been longstanding accounting problems within the oil and gas industry. For example, it has long been industry practice to prepare royalty and other interest owner checks between the 15th and 25th of the month following the month of production. Thus, for oil produced in December 1980, distribution of payments to interest owners occurred during January 15 to 25, 1981. But, subsequently, a very high percentage (up to 90 percent in some cases) of such payment distributions need to be adjusted in succeeding months. Such adjustments, which may pertain to a period of time ranging back from one month to several years, are needed for a variety of reasons--price corrections, state severance tax changes, ownership changes, miscellaneous corrections, etc. These longstanding accounting problems have been exacerbated by the greatly increased flow of information required for windfall profit tax purposes. As a result, many withholding errors cannot be detected and corrected by the March 31 cut-off date. As explained below, this was the case for crude oil produced in 1980.

Because withholding agents are prohibited from making tax liability adjustments after March 31 of the year following the year of crude oil removal, many producer-taxpayers are over- or underwithheld. Windfall profit tax statistics for calendar year 1980, for example, show that about 380,000 producers had tax overwithheld and about 342,000 producers had tax underwithheld. Each overwithheld producer must file a claim form with IRS to obtain a refund. Each underwithheld producer is required to file an annual excise tax return and pay the additional tax due. To illustrate, assume that around March 31, 1981, a producer receives a Form 6248 annual information return showing that the windfall profit tax for 1980 has been overwithheld by \$200. The purchaser or withholding agent cannot correct this error by adjusting later payments to this producer. Rather, the producer must obtain a refund from IRS by filing a Form 843, Claim for Overpayment, with a Form 6249, Computation of Overpaid Windfall Profit Tax. Or, the producer may take a credit for the overpayment on the 1980 income tax return.

Similarly, if the producer's 1980 windfall profit tax is underwithheld as of March 31, 1981, as reflected on the Form 6248 annual information return, the withholding agent cannot correct this error by adjusting later payments to the producer. Rather, the producer must file a Form 720 excise tax return with IRS and pay the amount due.

Even though withholding agents are not permitted to make withholding adjustments after the March 31 cut-off date, they

are required to prepare and file amended Form 6248 annual information returns if errors are discovered in the original submissions. This requirement is discussed in the final regulations for administrative aspects of the windfall profit tax, issued by IRS and published in the Federal Register on November 5, 1982:

" . . . when the person furnishing Form 6248 discovers that the form was in error . . . a corrected Form 6248 must be furnished no later than July 31 of the year following the year to which the correction relates if any error ascertained through June 30 in windfall profit tax liability, tax withheld, or amount under or overwithheld equals \$100 or more. All corrections of \$1 or more must be reflected in a corrected Form 6248 furnished at the time that the next year's Form 6248 is furnished. [These] . . . rules should substantially reduce the number of corrected Forms 6248 that would otherwise be required because only large errors must be corrected more frequently than annually."

Producer-taxpayers who receive amended information returns may, in turn, find it necessary to file amended income tax and/or excise tax returns. Recall the example used above of the producer who received, around March 31, 1981, a Form 6248 information return that showed \$200 overwithheld in 1980. Then, assume that on April 15, 1981, the producer filed a Form 1040 income tax return claiming a credit for the overpaid windfall profit tax. Later, around June 1981, assume that the withholding agent discovers an error in the Form 6248 information return and determines that the producer actually was overwithheld by \$350, not just \$200. In such a situation, IRS regulations require that the withholding agent prepare and distribute an amended information return. When the producer-taxpayer receives the amended return, perhaps in July 1981, this individual may file an amended income tax return to obtain a refund of the additional \$150.

In summary, under the present administrative regulations, producer-taxpayers often may need to file amended tax forms and/or additional tax forms. This is attributable partly to the oil and gas industry's accounting processes for payments to interest owners and partly to the volume of information flowing among operators, purchasers, and producers for windfall profit tax purposes. For these reasons, withholding agents cannot detect and correct many withholding errors by March 31, the cutoff date for making windfall profit tax liability adjustments for oil produced the previous year. And, to deal with the resulting additional and/or amended tax forms, IRS has to commit resources--returns processing equipment and personnel, examination personnel, etc.

Fortunately, however, there is a potential solution to this problem which could benefit both IRS and producer-taxpayers.

potential advantages of an
extended time frame for making
withholding adjustments seem to
outweigh possible disadvantages

Some industry representatives early stated that extending the time period for making withholding adjustments would prove beneficial to all concerned parties. Some companies suggested, for example, that withholding agents should be permitted to make adjustments for 2 years following the year of removal. Other companies suggested an even further extension, specifically that withholding adjustments be allowed at any time within the applicable statute of limitations. However, the oil industry groups have since reevaluated their early position. And, while IRS acknowledges that some benefits would accrue from an extended adjustment period, the Service is concerned about possible loss of control over the adjustment process. Nevertheless, we think the feasibility of extending the withholding adjustment period deserves an in-depth evaluation.

In March 1981, the American Petroleum Institute suggested that "withholding adjustments be allowed for a year following the date the annual statement is filed for the year in which the oil is removed." If an extended cut-off period were adopted, the Institute hypothesized that many favorable results could be expected. Specifically, the industry organization stated that its proposal would

"Accelerate the collection process of the Government.

"Provide additional assurance of revenue collection related to the adjustment process since the liability of the purchaser would not terminate until the end of the extended cut-off period.

"Insure more overall compliance by producers.

"Reduce the paperwork for all parties involved since the volume of amended [information] returns will be reduced by between 75%-90%.

"provide a better audit trail to the government and therefore supply the control over the adjustment process which under the current regulations may be lacking."¹

¹Comments dated March 20, 1981, submitted by the American Petroleum Institute, Mid-Continent Oil and Gas Association, Rocky Mountain Oil and Gas Association, and Western Oil and Gas Association, in response to proposed regulations published in the Federal Register on January 19, 1981.

Subsequently, in testimony before the House Committee on Ways and Means on April 27, 1982, a spokesperson for the American Petroleum Institute reiterated the need for ". . . a longer period in which to make withholding adjustments." At the same hearing, a spokesperson for the Independent Petroleum Association of America stated that the "liberalization of withholding adjustments . . . is generally a desired change."

The oil industry groups have since reevaluated their early position, however. The industry representatives now think that an extended period for making withholding adjustments would present the withholding agents difficulties, such as having to issue more amended information returns to producers. Also, there is some concern in the oil industry about the additional costs which withholding agents could incur in accounting for adjustments over a longer period of time. Nonetheless, in assessing the utility of an extended withholding adjustment period, the potential benefits that would accrue to IRS and producer-taxpayers also need to be taken into account.

If withholding agents were allowed a longer time frame to make withholding adjustments, many over- and underwithheld producer-taxpayers would be spared the burden of filing refund claim forms or excise tax returns. Instead, producer-taxpayers would have their balances corrected in subsequent months by withholding agents. Similarly, most windfall profit tax computation errors would not lead to the filing of amended returns. Again, adjustments would instead be made by withholding agents.

An extended adjustment period can be illustrated as follows. Assume, for instance, that producer A would receive a Form 6248 information return from withholding agent Z on March 31, 1984. The form might indicate that the producer's total windfall profit tax liability for calendar year 1983 was \$1,000 and that \$900 had been withheld and paid over to IRS. Ordinarily, producer A should then file an excise tax return (Form 720) with IRS and pay an additional \$100.

If the withholding adjustment time frame were extended, however, agent Z could inform producer A that an adjustment would be made in a subsequent month to remedy the deficit. This is feasible in many instances because withholding agents frequently have a continuing financial relationship with the same producer-taxpayers. That relationship generally entails having the agent compute and pay over, on a monthly basis, the amounts due producers from oil sales revenues. Agents, of course, are expected to withhold the windfall profit tax from payments made to producers.

Thus, agent Z would, in a subsequent month, reduce producer A's check by \$100 and pay that amount over to the government. Agent Z would include this amount on tax forms which already must be filed with IRS. However, producer A would not have to file Form 720 excise tax return and IRS would not have to expend

resources processing the form, examining it, ensuring collection, etc. Instead, producer A would simply use the amounts reported on the Form 6248 information return when filling out his or her personal income tax return (on which the windfall profit tax can be a deduction). Thus, if producer A were a cash basis taxpayer, the \$900 figure would be used in computing any deduction for 1983 income tax purposes, and the \$100 subsequent adjustment would be taken into account on the next year's income tax return. If producer A were an accrual basis taxpayer, the \$1,000 figure would be used for 1983.

An extended withholding adjustment time frame also would better reflect normal industry practices. As stated earlier, most royalty and other interest owner checks are prepared between the 15th and 25th of the month following the month of production. And a very high percentage of the checks are adjusted in succeeding months. Thus, the industry is already geared for the task of making adjustments for past payments.

Besides withholding agents' concerns about increased costs, IRS also has a concern about an extended period for withholding adjustments. The Service expressed this concern in the November 5, 1982, issuance of final regulations on administrative aspects of the windfall profit tax:

"The continuation of withholding adjustments after Form 6248 [annual information return] has been furnished would create the likelihood of a double payment by the producer if the adjustment increases withholding or a double refund if the adjustment decreases withholding. In order to avoid this result, the producer's entitlement to a refund claim or obligation to pay a balance due would have to be extended until after the expiration of the withholding adjustment period. The continuation of withholding adjustments suggestion has not been accepted due to the lengthy delay in refunds or payments that would follow."

We think IRS' concern can be addressed by modifying the Form 6248 information return. The form could contain, for instance, an appropriate line or space for the withholding agent to specify that under- or overwithholding will be adjusted in a subsequent payment and that the producer should not file a return or refund claim with IRS. Furthermore, in developing regulations pertaining to use of such a revised form, Treasury and IRS could provide withholding agents with guidance on acceptable time frames for making adjustments. By doing so, Treasury and IRS could minimize any problem with respect to delayed refunds or payments.

Apart from the concern expressed above, IRS also has some concerns about how the Service would monitor and control the adjustment process. Basically, IRS is uncertain as to how it could assure compliance on the part of withholding agents with respect to adjustments. In this regard, however, we note that IRS now has, and plans to maintain, a high level of examination coverage among withholding agents. And, during these examinations, revenue agents use computerized audit techniques to test compliance. Thus, in our view, IRS could develop effective compliance tests within the context of its current examination program. Of course, given the numerous issues and problems facing IRS in the windfall profit tax program, it is understandable that the Service has been unable to spend a great deal of time researching this issue. Nevertheless, it seems that an extended withholding adjustment period potentially has merit and thus should be thoroughly evaluated.

WINDFALL PROFIT TAX ADMINISTRATION
WOULD BE SIMPLIFIED IF IRS WERE ABLE
TO ISSUE DEFICIENCY NOTICES ON A
PROPERTY-BY-PROPERTY BASIS

Because the windfall profit tax on producers is calculated on a property-by-property basis, administration of the tax could be simplified if IRS were able to issue deficiency notices on that same basis. However, current law prohibits IRS from issuing more than one statutory notice of deficiency per taxpayer per taxable period. If the Congress were to amend the Internal Revenue Code in this regard, both the Service and affected taxpayers could benefit from faster resolution of tax liability issues.

Under section 4995(a)(8) of the Internal Revenue Code, a producer-taxpayer cannot be mailed a deficiency notice with respect to windfall profit tax liability until 2 months after the close of the calendar year in which the crude oil was removed from the premises. Further, section 6212(c) of the Internal Revenue Code provides that if IRS mails a notice of windfall profit tax deficiency to a producer-taxpayer, and the taxpayer then files a petition in a timely manner with the U.S. Tax Court for a deficiency redetermination, the Service cannot issue additional deficiency notices for the same taxable period with respect to this taxpayer.

However, with respect to the windfall profit tax, the latter code section has some undesirable effects. Specifically, because the windfall profit tax is calculated on a property-by-property basis, code section 6212(c) has the effect of forcing IRS to delay issuance of deficiency notices until the applicable statute of limitations expiration date is near. Code section 6212(c) restricts IRS to issuing a producer only one deficiency

notice with respect to a given taxable quarter. For this reason, the Service needs all available time within the applicable statute of limitations period to examine oil properties and consolidate the deficiencies of producers who own interests in more than one property. This procedure has the effect of (1) delaying revenue flows to the government and/or (2) increasing taxpayers' interest costs. In some instances, tax revenues may be foregone entirely. The following example shows more specifically the kinds of problems presented IRS and taxpayers by existing law. The example is based on a producer-taxpayer who has an interest in two properties--property A and property B. The taxpayer is an integrated oil company with an income tax year ending December 31.

Assume that windfall profit tax is withheld by a first purchaser on the integrated oil company's interest in property A. On the basis of certifications submitted by the operator that the oil on property A is tier 3 newly discovered oil, the first purchaser withholds at the 30 percent windfall profit tax rate for the first taxable quarter in 1980. Late in 1981, however, a revenue agent determines that the oil on property A is not newly discovered oil but is tier 1 oil--which is taxed at a 70 percent rate for integrated oil companies--and the Service issues the taxpayer a deficiency notice for the first taxable period in 1980.

Assume further that when this statutory notice of deficiency is sent on the taxpayer's interest in property A, there has been no examination related to property B. Windfall tax for the first quarter of 1980 has been withheld on the integrated oil company's interest in property B at the 60 percent rate, on the basis of certifications submitted by the operator that the oil on property B was tier 2 stripper oil. In early 1982, however, an IRS examination related to property B results in a determination that the oil was not stripper oil but was tier 1 oil which should have been taxed at a 70 percent rate. By the time this determination is made, however, a deficiency notice has already been sent to the taxpayer with respect to property A for the first quarter of 1980. Thus, no other statutory notice can be sent concerning windfall profit tax liability for that quarter, and the government cannot collect the additional 1980 tax due on this taxpayer's interest in property B.

As indicated above, a producer-taxpayer's various properties can be widely dispersed geographically and subject to examination at different times. And, many producer-taxpayers do have interests in multiple properties. Large oil companies themselves, for example, often are producer-taxpayers for windfall profit tax purposes and some own interests in thousands of properties. Even the average producer-taxpayer has an interest in more than one oil property. Return statistics for 1980, for instance, showed that an average of 2.2 windfall profit tax information returns were filed per producer-taxpayer.

Therefore, to prevent problems in the deficiency notice area, IRS has decided that it must delay issuance of such notices and must establish and effectively manage a case control system. IRS has further decided that it needs 10 months time to consolidate examination results and then issue each affected taxpayer a single deficiency notice. Thus, for example, for all windfall profit tax returns due May 31, 1982, IRS will begin the deficiency notice consolidation process on July 31, 1984--10 months before the statute of limitations will expire on those returns, i.e., May 31, 1985.

This approach has effects on revenue flows and interest charges. For example, IRS might examine a May 1982 tax return in May 1983 and identify a tax deficiency. However, it generally will not issue a statutory notice of deficiency with respect to that examination until early 1985. This can delay revenue flows to the government. Also, this approach can have a negative effect on taxpayers. In the above example, the subject taxpayer who ultimately pays the additional taxes due also must pay interest on that amount from May 31, 1982, until the date payment is made. And whereas IRS will have made a determination of the amount due with respect to one examination in 1983, it will make no effort to assess the tax until 1985. The taxpayer thus will pay interest on the amount due for 2 years longer than otherwise might have been necessary.

Thus, there is a need to consider a revision to the Internal Revenue Code for deficiency notices with respect to the windfall profit tax. Tax revenue collection and case control administration could be facilitated if the Internal Revenue Code were amended to allow IRS to issue deficiency notices after examination of each property, without precluding issuance of subsequent notices covering a producer's interests in other properties during the same quarter. Such a legislative change would permit faster resolution of producers' windfall profit tax liability with respect to properties examined. In turn, this could result in interest savings to producers if the deficiencies asserted by IRS examiners were sustained. Given the current interest rate of 11 percent on assessed tax deficiencies, interest savings could be considerable. A legislative change would also lessen tax enforcement problems related to tracking and coordinating the various statute of limitations dates which can arise in multiple property situations. The amendment could also reduce the potential for missed statute of limitations dates and thus could enhance IRS' revenue collection efforts.

IRS has recognized that there is an apparent need for a legislative change in this regard. It therefore has developed a proposed change to the law and forwarded the proposal to Treasury for review. Furthermore, Treasury has determined that it considers IRS' proposal to be appropriate.

THE PROCEDURAL RULES FOR APPEALS SHOULD BE REVISED

Until recently, producer-taxpayers could separately appeal the same issue, such as the tier of oil from a given property, both to IRS and to the courts. This situation existed for all producer-taxpayers, including individuals and each partner in a partnership. In the Tax Equity and Fiscal Responsibility Act of 1982, however, Congress specified that, for certain issues, partnerships would be treated as taxable entities for appeals purposes, for both administrative and court appeals. That is, for certain issues relating to a given oil property, each partner in a partnership no longer has the right to a separate appeal. Instead, a consolidated appeals procedure was adopted.

The concept of a partnership as a single taxable entity provides a precedent for actions which could facilitate windfall profit tax administration. That is, for certain issues relating to a given oil property, a consolidated appeals procedure for producer-taxpayers who are not members of a partnership may be more efficient than allowing each individual to appeal separately. IRS recently made a regulatory change to eliminate duplicative administrative appeals for most producer-taxpayers but legislation is need to preclude duplicative judicial appeals for taxpayers who are not members of a partnership.

Present rules allow duplicative judicial appeals of the same issues

Appeals rights are an important part of the IRS-taxpayer relationship. Because various aspects of the Internal Revenue laws are complex and can lead to disagreements, the Service has an appeals system. If a taxpayer does not agree with the changes proposed by an IRS examiner, a single level of appeal is available within the Service. Generally, this level is an appeals conference conducted by the Appeals Office within the applicable IRS district. If agreement is not reached at the appeals conference, the taxpayer may take the case to court.

Until IRS changed its administrative appeals rules in June 1983, each producer whose windfall profit tax liability was affected by an IRS examiner's adjustments was entitled to a separate appeals conference to contest the examiner's findings. Conceivably then, for any given issue, there could have been as many administrative hearings as there were interest owners in an oil property. Similarly, a large number of duplicative court cases can still occur. As previously mentioned, it is not uncommon to have 50 or more owners of a single oil-producing property. And, except for partnership situations, each of these owners can separately appeal the same issue judicially within the court system.

As of November 1982, an appeals inventory, whether administrative or judicial, had yet to accumulate with respect to windfall profit tax cases. This was because, as discussed in chapter 4, most of the Service's examination cases had been in a suspense status due to property definition uncertainties. Service officials estimate, however, that the approximately 3,700 suspended examination cases will affect over 100,000 producer-taxpayers when deficiency notices are issued. Thus, the potential appeals case workload is very large and seems certain to grow.

Fortunately, however, recent enactment of the Tax Equity and Fiscal Responsibility Act of 1982 should result in streamlined tax administration with respect to partnership cases, including oil industry partnerships.

Recent legislation has
streamlined the partnership
examination and appeals processes

The Tax Equity and Fiscal Responsibility Act of 1982 provides that partnership tax audits will be handled administratively as if the partnership were a separate and distinct taxpayer. This legislation is designed to alleviate the procedural and logistical difficulties experienced by IRS in reaching tax liability determinations (whether administrative or judicial) on tax-shelter and other partnership activities. Under section 6232 of the Internal Revenue Code, the new treatment of partnership items is also specifically extended to the windfall profit tax.

As a general tax principle, partnerships are conduits or pass-through entities rather than separate taxpayers or taxable entities. That is, all items of partnership income, deduction, and credit are allocated among the partners for inclusion in their respective income tax returns. Consequently, when IRS proposed adjustments to a partnership's taxable income, the Service had to assess the resulting tax deficiencies against each of the partners as appropriate. Before passage of the 1982 Act, determining and assessing such tax deficiencies presented IRS severe administrative difficulties, particularly in cases of large partnerships where partners resided in different IRS districts.

The Tax Equity and Fiscal Responsibility Act of 1982 sought to alleviate the proliferation of multiple-party tax controversies involving partnership issues--issues which result in duplicative cases that generally must be disposed of one by one, causing bottlenecks in IRS and the courts. For instance, the 1982 Act provided that partnership tax audits will be handled administratively as if the partnership were a separate and distinct taxpayer. That is, the tax treatment of items of

partnership income, loss, deductions, and credits are determined at the partnership level in a unified partnership proceeding rather than in separate proceedings with the partners. A partnership level administrative proceeding will go through the same process of examination, appeal, settlement, notice of final determination, etc., that generally applies to a tax audit. All partners will be

- notified by IRS of the start of a partnership administrative proceeding,
- allowed to participate in the proceeding, and
- notified by IRS of the final partnership administrative adjustment.

If the partnership return lists more than 100 partners, IRS is required to provide notice only to partners with an interest in partnership profits of 1 percent or greater. A tax matters partner will be designated to receive notice on behalf of other partners.

Within 90 days after notice of the final partnership administrative adjustment, the tax matters partner may file a petition for judicial review. Other partners may not file suit during the 90-day period. After the 90-day period, any other partner may file a petition if the tax matters partner has not filed. The final partnership administrative adjustment generally is binding on all partners if a petition for judicial review is not filed within 150 days. The petition may be filed in the Tax Court, the district court for the district in which the partnership has its principal place of business, or the Claims Court. However, only one court acquires jurisdiction, usually as chosen by the tax matters partner. The new partnership rules for administrative and judicial proceedings do not apply to partnerships with 10 or fewer partners, but these small partnerships may elect to be covered by the rules.

As mentioned, under section 6232 of the code, the new tax treatment also applies to partnership windfall profit tax items. A partnership windfall profit tax item is any item relating to computation of the windfall profit tax on crude oil produced by the partnership which Treasury determines by regulation to be more appropriately determined at the partnership rather than the partner level. The new act applies to the determination, examination, and collection of windfall profit tax with respect to oil removed in taxable periods beginning after December 1982. Each partner will remain primarily liable for the windfall profit tax on allocable shares of taxable crude oil produced by the partnership. But the partnership will compute and withhold the windfall profit tax.

In summary, the new law should largely eliminate duplicative appeals, both administrative and judicial, of the same partnership items at issue. With enactment of this law, judicial review of final partnership administrative adjustments generally is limited to a single court case. In our view, windfall profit tax administration could be simplified if this concept were applicable to all of the interest owners of a property, in addition to partners in a partnerships. IRS already has made a regulatory change to eliminate duplicative administrative appeals; however, legislation is needed to eliminate duplicative judicial appeals.

Recent IRS regulations changed administrative appeals procedures, but legislation is needed with respect to judicial appeals

For individual producer-taxpayers and all others who are not partners in a partnership, IRS recently amended appeals procedures for operator or "oil" issues, such as oil removal price, base price, oil tier, and severance tax adjustment. These issues are not unique to an individual producer but rather apply to all owners of oil from a given property. For example, once it is determined that oil from a given property is a certain tier, that tier should uniformly apply to all interest owners of the property. Under a centralized procedure, all appeals of the results of IRS examinations on these kinds of issues would be held at the same time. The Service published a proposed amendment to this effect as a notice in the Federal Register on December 2, 1982, to allow the public an opportunity to comment.

In written comments and at an IRS hearing conducted January 18, 1983, oil industry representatives asked the Service to reconsider the proposed regulations creating a consolidated hearings process. The oil producers raised at least two general concerns:

- One was that some of the items listed as "oil" items in the proposed amendments, such as pricing data, may vary from producer to producer within the same lease and therefore may be proprietary information and would be more appropriately handled in an individual conference.
- The other concern was that conducting administrative appeals hearings on a property basis may increase the number of conferences, rather than limit them, because of the large number of properties involved in the windfall profit tax.

IRS considered these concerns before issuing final regulations on June 2, 1983, requiring consolidated administrative appeals conferences. For example, the final regulations provide an exception to the consolidated hearings process for those producers who can demonstrate that certain oil-related items, such as pricing, do involve proprietary information. Regarding the second concern, however, IRS officials still believed that conducting administrative appeals hearings on a property basis for oil-related items would result in fewer and more efficient conferences than conducting such hearings on an individual producer basis. Under previous procedures, for example, Service officials had already found that administrative appeals conferences were taking place in different areas of the United States on identical oil-related items involving the same property.

Moreover, the procedural amendment does not change the present administrative appeals rights for "producer" issues, such as whether the producer qualified for tax exemption or for independent producer status. Unlike oil issues, producer issues are unique to each individual producer or owner. Consequently, each producer still is entitled to a separate or individual appeals conference on such issues.

The Service's recent regulatory amendment for producer-taxpayers who are not partners in a partnership, however, consolidates administrative appeals only; these producers can still appeal their cases individually to the judicial system. This result, that is, allowing a given property's oil issues to culminate in duplicative judicial appeals, seems inefficient. Insofar as partnerships are involved, the Tax Equity and Fiscal Responsibility Act of 1982 generally will limit partners to a single judicial review. However, producer-taxpayers who are not partners, but who own interests in the same oil property, can still appeal the same issue separately to the courts. Legislation is needed to alleviate this potentially costly and unnecessary procedure.

Such legislation perhaps could have provisions similar to those in the Tax Equity and Fiscal Responsibility Act. The 1982 Act, for example, provides that a tax matters partner will serve as the focal point for filing a petition for judicial review of a final partnership administrative adjustment. For individuals and entities not covered by the act, namely producer-taxpayers who are not partners but who own interests in the same oil property, the focal point for initiating judicial review of an oil-related item perhaps could be the operator of the oil property or a designated working interest owner. Generally, the operator owns a working interest in the property and also is in the best position to marshal facts about the property's oil-related items, such as the tier or tiers of the crude oil, the quantity of oil in each tier, and the adjusted base price

and the removal price of the oil. Indeed, it is the operator who is already required to provide this kind of information monthly to first purchasers and other windfall profit tax withholding agents.

To reiterate, allowing a given property's oil-related issues to result in duplicative appeals seems inefficient. IRS has issued final regulations to alleviate the potential for duplicative administrative appeals. However, legislation is needed to alleviate the potential for duplicative judicial appeals of oil-related issues by producer-taxpayers who are not partners.

As discussed above, appeals procedures, as well as procedures for withholding adjustments and deficiency notices, are all areas which could be streamlined to facilitate administration of the windfall profit tax. However, regardless of whether improvements are made in these areas, a computerized information system is essential for IRS to effectively manage and coordinate the tremendous volume of data generated by windfall profit tax compliance activities. Without an automated system, there is potential for inadequate control or coordination of compliance activities and loss of tax revenue.

IMPLEMENTATION OF A COMPUTERIZED INFORMATION SYSTEM

The Service early recognized the need for a computerized windfall profit tax information system and planned to develop a system with two components--a working file data base and a case control system. It took IRS a year longer than anticipated to implement the two components of this computerized windfall profit tax information system. Among other reasons, the delay resulted from vendor hardware and software acquisition and development problems. The working file data base was not operative until November 1982; the case control system became partially operative in October 1983. Development costs for the two components were estimated by IRS to be about \$1.8 million.

The effect of the delayed windfall profit tax computerized information system components was lessened by implementation of several interim procedures. For example, IRS implemented an interim case control system. However, this interim system was difficult to manage because it generated voluminous and cumbersome paper output--as much as 33,000 pages of paper every 2 weeks.

The planned system was behind schedule

The Service early recognized the need for an integrated computer information system to manage the expected large volume of windfall profit tax data. As early as September 1980, national office personnel began studies to identify windfall profit tax information system needs. IRS officials decided, in January 1981, to acquire computer hardware so the Service could develop a windfall profit tax information system consisting of two components--a working file data base and a case control system. The working file data base will allow IRS to manage and consolidate all the windfall profit tax information obtained from filed returns and claims and information extracted from processing against the master files. The information will be merged into the working file data base to provide for on-line access and/or periodic listings as needed to administer the Service's compliance program.

The other component, the case control system, will be developed for on-line access to control windfall profit tax examination and collection cases and, if necessary, appealed cases. This system will allow IRS to identify the status and location of the cases, as well as identify the interrelationships among producers, operators, and/or properties. In addition, the on-line case control system will manage and issue windfall profit tax statute of limitations notices to applicable producer-taxpayers.

Service officials have decided that the system's two components will be developed on a Honeywell Level VI computer, to be located at the Austin Service Center. This service center was designated to manage the planned computer information system because IRS' Southwest region has most of the Service's total workload in the windfall profit tax program.

Service officials planned to have the working file data base operational by October 1981, and the case control system operational by April 1982. However, this schedule slipped by approximately a year. The working file became operational in November 1982, and the case control system became operational in late 1983.

Implementation of the Honeywell Level VI computerized information system was delayed partly by hardware and software acquisition problems. The computer has been located in the Austin Service Center since June 1980. Between June 1980 and June 1981, IRS leased and used the equipment for test processing of various types of tax returns. Then, from June 1981 until September 1981, IRS conducted feasibility studies to determine the hardware needed for the computerized windfall profit tax information system and decided upon the Honeywell Level VI.

Although purchased in September 1981, IRS did not begin using the computer in the windfall profit tax program until May 1982. This time lag resulted from several problems. First, IRS determined that the Honeywell Level VI, as configured for the test processing of other returns, was not adequate for windfall profit tax purposes. Two additional disc drives and other hardware enhancements were needed. These items were delivered in December 1981 under a 90-day delivery clause of the September 1981 contract.

Service officials began negotiating with the vendor in September 1981 to acquire the technical support needed to develop software programs. Programming and testing of the Honeywell Level VI computerized information system was estimated to require 15 staff months for each of the system's two components. The Service did not have the technical expertise available in-house and, therefore, attempted to negotiate a software development contract with Honeywell. However, Honeywell could not provide the required number of people to develop the software.

On April 28, 1982, the Service completed negotiations on a contract with another vendor (Systems Architects, Inc.) to provide technical staff to develop software for the working file data base. In addition, under provisions of a separate purchase order, arrangements were made for a Honeywell employee to serve as a technical advisor to IRS. With this technical support, the Service was able to bring the working file data base on-line by November 1982.

The Service also negotiated a separate contract to develop programs for the case control system. An IRS official told us that this contract was negotiated in August 1982, and that as a result, the Service would have an on-line case control system operating by early 1984.

Interim procedures were
administratively cumbersome

Because the planned computerized systems were not operational, IRS took interim steps to facilitate management of its compliance activities. First, IRS personnel wrote three programs to provide access to windfall profit tax information at the Service's national computer center. These programs gave compliance staff certain windfall profit tax discrepancy data to use in identifying potential cases for examination.

Another temporary procedure involved development and operation of an interim case control system. IRS needed to be able to identify the status and location of its cases and issue deficiency notices to producer-taxpayers before expiration of the applicable 3-year statute of limitations. The first windfall profit tax returns were due to be filed by May 31, 1980, i.e., 2 months after the end of March 1980, the first

taxable period under the then-new Crude Oil Windfall Profit Tax Act.² For these initial returns, the 3-year statute of limitations expired on May 31, 1983. Generally, IRS wants to identify delinquent producer-taxpayers and begin deficiency notice procedures 10 months before the applicable limitations period expires. To meet this time frame for the first taxable period's returns, IRS needed to have a case control system operating by July 31, 1982.

Recognizing that the on-line case control system would not be ready by the desired date, IRS initiated, on April 17, 1982, part of an interim case control system. The full interim system was completed in July 1982 and operated until the Honeywell Level VI system became operational in late 1983.

The main disadvantage of the interim case control system was that it generated voluminous and cumbersome paper output. For example, the system output 13 biweekly reports and 4 as-needed reports. During the initial validation listing, processing of 1,500 windfall profit tax cases generated 500 pages of paper. That meant that 500 pages of paper would be generated every 2 weeks from a relatively low inventory of cases. At that time, an IRS official estimated, however, that the interim case control system would eventually handle 100,000 windfall profit tax cases. This would produce about 33,333 pages of paper every 2 weeks to be mailed to applicable district offices. To help reduce this volume of paper, IRS later began distributing closed case information on microfiche.

One situation affecting the interim case control system was that the Service had, until late 1982, held in a suspended status the closure of most windfall profit tax examination cases due to uncertainties about the property concept. The suspension temporarily reduced the work load of the interim case control system. After the suspension, a paper backlog occurred. For example, one IRS official estimated that, as of December 1982, over 3,700 cases were waiting to be closed. The interim case control system necessitated that case information be input manually, including the spread of tax liability adjustments among numerous producers.

²Generally, a taxable period is 3 months. But, because the Crude Oil Windfall Profit Tax Act applies to domestic oil produced only after February 1980, the first taxable period for the windfall profit tax was 1 month--March 1980.

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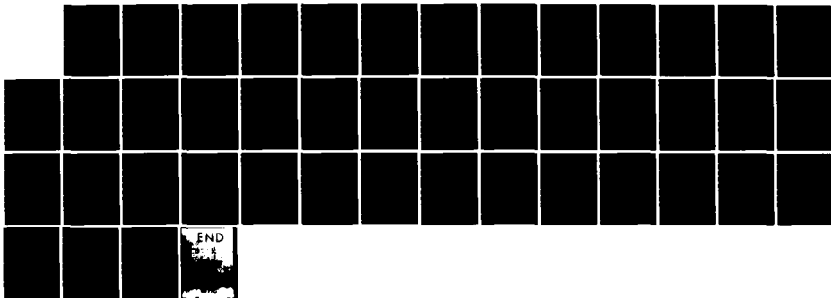
IRS' ADMINISTRATION OF THE CRUDE OIL WINDFALL PROFIT
TAX ACT OF 1980(U) GENERAL ACCOUNTING OFFICE WASHINGTON
DC GENERAL GOVERNMENT DIV 18 JUN 84 GAO/GGD-84-15

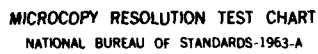
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As mentioned, the computerized case control system became partially operational in late 1983. Since then, IRS has continued to develop the system's utility, not only by inputting relevant windfall profit tax data but also by providing training to users. For example, a pilot course, with participants from various regions, was conducted in February 1984.

CONCLUSIONS

The complex windfall profit tax has presented Treasury and IRS a major tax administration challenge. Adapting normal tax assessment and collection approaches to the crude oil tax has proven to be a difficult task. This is because the unique structure of the tax causes IRS' workload to increase geometrically as it deals initially with purchasers and then subsequently with operators and producers.

Although administering the windfall profit tax involves many difficulties, there are several potential means for mitigating some of these difficulties. An extended period for withholding adjustments might prove worthwhile as a means for limiting IRS' workload. If Treasury and IRS can overcome the problems associated with the extended withholding adjustment concept, then benefits in terms of reduced paperwork would accrue to both IRS and taxpayers.

Also, the Congress could simplify windfall profit tax administration by amending the laws governing (1) IRS' issuance of statutory notices of deficiencies and (2) the judicial appeals process. The former action would substantially reduce IRS' case control burden and could save taxpayers money in the form of accrued interest. The latter action would be consistent with previous congressional actions and with IRS' issuance of final regulations regarding administrative appeals and could help avoid the development of a substantial judicial appeals case backlog.

On a related matter, it is clear that IRS needs to continue development of its windfall profit tax computer support system. A computerized information system is essential for IRS to effectively manage and coordinate the windfall profit tax program. Program data elements and interrelationships are simply too voluminous and complex to be controlled manually.

RECOMMENDATION TO THE SECRETARY OF THE TREASURY

To determine whether windfall profit tax administration can be facilitated under existing law, we recommend that the Secretary, in consultation with IRS, conduct a study of the advantages and disadvantages involved in allowing purchasers an extended period in which to correct windfall profit tax withholding errors. The study should seek, among other things, to

assess potential benefits to be derived and the related costs, and should also determine whether an effective compliance program could be maintained under a revised withholding system.

RECOMMENDATIONS TO THE CONGRESS

IRS needs to be able to issue deficiency notices after examination of each oil-producing property, without precluding later issuance of additional notices covering the producers' interests in other properties during the same quarter. To effect this procedure, we recommend that the Congress amend section 6212(c) of the Internal Revenue Code. A revised procedure has advantages for both the Service and taxpayers, including faster resolution of tax liability determinations. We suggest that the statutory language in appendix V be considered.

Another windfall profit tax area which needs legislative action is the appeals process. We recommend that the Congress pass legislation to consolidate judicial appeals for a given property's "oil" issues. Suggested statutory language is presented in appendix VI. A consolidated appeals process would conserve both IRS and judicial resources, while also protecting taxpayers' rights. Precedent legislation is provided by title IV of the Tax Equity and Fiscal Responsibility Act of 1982 which, among other matters, attempts to avoid duplicative judicial reviews of the tax treatment of partnership items.

AGENCY COMMENTS AND OUR EVALUATION

By letter dated August 26, 1983, the Assistant Secretary for Tax Policy, Department of the Treasury, and the Commissioner of Internal Revenue agreed to consider the feasibility of conducting a study regarding an extended period for purchasers to correct windfall profit tax withholding errors. The Assistant Secretary and the Commissioner also agreed with our legislative recommendations to the Congress regarding deficiency notices and the appeals process. Appendix I contains a copy of the Assistant Secretary's and the Commissioner's comments.



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

AUG 20

Mr. William J. Anderson
Director, General Government Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Anderson:

Thank you for the opportunity to review your draft report entitled "IRS' Administration of the Crude Oil Windfall Profit Tax Act of 1980".

The report presents problems which the Service has experienced in administering the windfall profit tax and with a few exceptions, we are in basic agreement with the report's conclusions and recommendations. Detailed comments on each of the report recommendations are enclosed.

We appreciate GAO's recognition of the complexities of the windfall profit tax and of IRS' progress in implementing examination and related compliance programs. In connection with these complexities, the report contains two legislative recommendations to Congress which are designed to enhance the administration of the windfall profit tax. We have been reviewing and will continue to review the statute for other provisions that could be simplified to make the Act more administrable.

We hope that these comments, as well as those provided informally to your staff, will be helpful in preparing your final report.

Sincerely,

John E. Chapoton
Assistant Secretary (Tax Policy)

Roscoe L. Eggen, Commissioner
Internal Revenue Service

Enclosure

Recommendation (p. 13)

We recommend that the Secretary of the Treasury comply with the accounting requirements of the Crude Oil Windfall Profit Tax Act. Specifically, the Secretary should allocate net windfall profit tax revenues into the established Windfall Profit Tax Account and should establish and record the net revenues into three subaccounts as required by law.

Response

The Budget of the United States Government for Fiscal Year 1984, at p. 6-41, contains an allocation of windfall profit tax receipts. The total receipts shown as available for allocation are the net receipts based on estimates of anticipated windfall profit tax revenues. Similar estimates of net windfall profit tax receipts and allocations of those receipts to appropriate subaccounts have appeared in the Budgets for Fiscal Years 1982 and 1983.

Maintenance of the Treasury Windfall Profit Tax Account will be adjusted to conform to the statutory requirement that net receipts be accounted for and that they be segregated in three subaccounts as recommended by the GAO draft report.

With respect to the text of Chapter 2 of the draft report it is suggested that the \$227.3 billion amount be identified as a revenue estimate based upon 1980 projections of windfall profit tax receipts and not as a "goal." Current Treasury Department estimates of projected receipts are not a "shortfall" but are merely estimates based upon different incomes assumptions attributable to the recent rapid decline in crude oil prices.

Recommendation (p. 48, no. 1)

Develop and implement a more effective means for selecting oil property operators for examination. One means for accomplishing that objective would entail requiring operators to submit annual information returns to IRS. This, of course, would require issuance of Treasury Department regulations. The returns could contain property-by-property data on such items as oil production volume, oil tiers, base prices, and State severance taxes. IRS could use such information as a basis for developing an effective operator examination selection approach. In considering this option, however, the increased paperwork burden on and costs to the oil industry should be taken into account.

Response

The IRS needs additional information concerning operators to aid in administration of the Windfall Profit Tax law. This operator information is needed in order to classify properties for examination when books and records concerning particular properties are usually located at the operator's business office. The Service has initiated several steps to develop and maintain a list of operators of particular properties. These steps include the following:

- Some 85,000 Forms 6458 certification of exempt stripper oil filers are being requested to furnish name, address, and taxpayer identification number of the operator.
- Excise tax regulation 51.4995-2(a) and (c) and 51.4995-5(c) are being reviewed to determine if revision is needed to require operator data.
- Form 6458 "Certification and Election Form" has been suggested for revision to require operator information under certain circumstances.

The Service has the capability to maintain a list of those properties that have been verified (on a mini computer) for subsequent classification and field examination usage. The Service also subscribes to several oil and gas services which provide data concerning operators of particular properties, etc., within specified geographical areas. One of these programs includes information for 17 states and cover approximately 85 percent of oil and gas production in the U.S.

Recommendation (p. 48 , no. 2)

Develop and implement an effective means for assuring that the windfall profit tax is assessed and paid on oil involved in multiple transactions. In this regard, requiring the use of a "tax paid" certificate or similar document throughout the oil production and marketing process may be an effective means for resolving this problem. Again, however, the increased paperwork burden on and costs to the oil industry need to be taken into account. Regardless, we think the issue is sufficiently significant for IRS to evaluate the need for such a certificate. If such a certificate is deemed necessary, either Treasury regulations should be promulgated or, if needed, appropriate legislation should be sought.

Response

The Service agrees with the recommendation, has previously evaluated the need for such a certification, and will propose legislation to Treasury which would amend Chapter 45 of the Code to empower the Service with the right of requiring evidence that the correct amount of windfall profit tax has been withheld or otherwise paid. The certification in effect would "follow the oil" and would incorporate data reflecting the property from which the oil was removed and its location; the type, tier, gravity, removal price, and the amount of tax withheld or deposited. (Copy of proposal attached.)

WINDFALL PROFIT TAX PROPOSALS

Recommendation

Amend Chapter 45 of the Code to empower the Service with the right to require evidence that the correct amount of windfall profit tax has been withheld or otherwise paid. The particular evidence in mind is a written certification stating the pertinent facts: the property from which the oil was removed and its location; and the type, tier, gravity, removal price and amount of tax withheld or deposited.

The crude oil purchaser, not necessarily a first purchaser, would be liable for the tax in the absence of valid evidence.

Background

Internal Revenue examination personnel have encountered frequent instances wherein oil producers and brokers, engaged in the buying and reselling of oil or exchanges of oil, subsequent to production and prior to delivery to the refinery, have sought to frustrate administration of the windfall profit tax. Common features of those transactions where frustration of tax is a principal motive, are (1) a refusal to cooperate with IRS personnel in providing sufficient data to determine whether the correct amount of tax has been paid, and (2) a multiplicity of purchases and sales or exchanges, and a multiplicity of entities/parties through whom these sales or exchanges ostensibly are effected. These features render very difficult and time consuming the tracing of the oil back to production--i.e., where was it produced, at what adjusted base price and removal price, and from which tier of oil.

The tax on any given barrel of oil can differ considerably from the tax on any other barrel. When oil is not subject to withholding, there is an enhanced opportunity to present the oil as low taxed oil or exempt oil. Notwithstanding the capabilities of the Service's examination personnel, uncovering schemes to thwart administration of the tax, can be very costly in terms of limited examination resources.

Recommendation (p. 49, no. 1)

Develop effective, coordinated procedures for examining net income limitation claims and adjustments. Because this provision of the Windfall Act involves billions of dollars in refunds, considerable attention should be devoted to developing effective examination procedures. Effective cross-district and cross-tax-year coordination will be required to (1) assess dispersed windfall profit tax and income tax records and (2) avoid duplication of effort and its potential effects--inconsistencies of results, inequities to taxpayers, and strained IRS-taxpayer relations.

Response

Net income limitation (NIL) claims and adjustments present unique problems for the Service where an excise tax (Windfall Profit Tax) incorporates the necessity to make income computations. The recommendation to develop effective, coordinated examination procedures is well taken. IRM Supplement 42RDD-57 (dated January 5, 1983) provides some of these procedures in section 6 and additional guidance is planned for inclusion in the Techniques Handbook for Specialized Industries - Oil and Gas (Chapter 900 - Windfall Profit Tax) which is to be revised and issued later this year.

Specialized areas of NIL interest include application of the statute when a portion of the proceeds from a property's crude oil is held in escrow. IRS is currently considering a legislative proposal in this area and hopes to have it ready for an early submission to Treasury.

Recommendation (p. 49, no. 2)

Analyze the windfall profit tax liability effects of IRS' May 1982 revenue rulings, which discuss the allowability of various States' severance taxes. The Service needs to decide whether adjustments to affected taxpayers' windfall profit tax liability can and should be made for past taxable periods.

Response

The May 1982 revenue rulings concerning states' severance taxes have been made available to all Regional Windfall Profit Tax Coordinators and all agents working Windfall Profit Tax cases. Any taxpayer's examination would include the severance tax issue. However, we do not plan to establish a separate examination classification and selection program based on severance tax alone. The classification criteria of Windfall Profit Tax returns to be examined is rather broad based to ensure audit coverage at various levels (i.e., first purchaser/qualified disburser, operator and producer). Varied selection criteria are often used on stratified reports (i.e., liability, dollar size, volumes of exempt oil, volume of oil by tier, claims for refund where 6248's reflect lesser tax actually paid) to enable the Service to utilize its resources in the area of greatest tax potential. We do not believe that the severance tax issue alone should be a criteria unless it is considered with other issues for both selection and examination. Our present procedures incorporate this approach.

Recommendation (p. 49, no. 3)

The Service's ability to structure an effective windfall profit tax collection program depends largely on the availability, completeness, and accuracy of Forms 6248 annual information returns. Therefore, we recommend that the Commissioner of Internal Revenue require revenue agents to perform, where practical during first purchaser examinations, a reconciliation of the withholding agent's quarterly excise tax returns (Forms 720) for the year with the producers' windfall profit tax liability as shown on annual information returns (Forms 6248). In performing such reconciliations, examiners should particularly try to identify systemic problems with the withholding agents' computer operations.

Response

Any examination of a first purchaser/qualified disburser includes a verification as to withholding on producers and the subsequent deposit, reporting and payment of withheld taxes to the Service. Draft procedures IRM 4232.8 Techniques Handbook for Specialized Industries - Oil and Gas (Chapter 900 Windfall Profit Tax) provide for reconciliation of Forms 6248. These procedures have been in effect since establishment of the Windfall Profit Tax Program as interim instructions and will be formalized later this year when the revised handbook is issued. In addition to these audit techniques, the Service transcribes all Forms 6248 for computer input to the Windfall Profit Tax working file. Magnetic tape files of Forms 6248 data are reconciled to the total dollar value, and number of Forms 6248 submitted for first purchaser and qualified disbursers. P.L. 97-248 added IRC Section 6011(e) which provides that the Secretary shall prescribe regulations providing standards for determining which returns must be filed on magnetic media, or in other machine readable form, and Forms 6248, being one of these returns, will enhance the capabilities of the Service to verify, check, and cross check Windfall Profit Tax withholding. Comparison of total Forms 720 withheld liabilities to total of amounts shown as withheld Windfall Profit Tax on Forms 6248, could be accomplished by a computer program match if the Form 720, line 50 data is broken out into two separate entries (i.e., Windfall Profit Tax amount withheld and Windfall Profit Tax producer liability). The Windfall Profit Tax Control Group is presently considering this approach together with the possibility of moving windfall profit tax reporting to a separate return.

Recommendation (p. 49, no. 4)

To give the Criminal Investigation Division a more visible and more effective presence in the windfall profit tax program, we recommend that the Commissioner of Internal Revenue have the Division begin some information gathering efforts. Potential targets which should be considered include multiple transaction oil, stripper oil, and tank bottom oil.

Response

We agree to consider the feasibility of conducting such an information gathering project.

Recommendation (p. 67)

With respect to tank bottom oil, we recommend that the Secretary of the Treasury develop and issue regulations directed at minimizing revenue loss possibilities and tax evasion opportunities. In so doing, the Secretary should consider the feasibility of taxing reclaimed oil when it is moved from the treating facility to the refinery. Such an approach seemingly would foreclose the revenue loss possibilities and the tax evasion opportunities in this area.

Response

We agree that the issues relating to tank bottom oil should be addressed, and we anticipate that the necessary guidelines and rules will be issued in the not-to-distant future.

GAO Findings

A Computerized Information System Must be Implemented (page 83)
Interim Procedures Are Administratively Cumbersome (page 85)

Response

Although vendor hardware and software acquisition problems were encountered, the Service for the most part overcame these problems with the use of alternative automated means of access to the WPT data files. However, the limitations and problems concerning the data inputs to these files could not so readily be overcome. The draft report at page 35 discusses the nonfiling of WPT information returns, Form 6248, for 1980 and at page 40 the incompleteness or inaccuracy of many of the Forms 6248 that were filed.

The report addresses the working file and the case control file and states that the Service is currently a year behind schedule in their development. While the working file was behind schedule, all planned phases are now operational. The case control system will be operational by October 1983, the originally scheduled completion date.

Recommendation (P. 87)

We recommend that the Secretary, in consultation with IRS, conduct a study of the advantages and disadvantages involved in allowing purchasers an extended period in which to correct windfall profit tax withholding errors. The study should seek, among other things, to assess potential benefits to be derived and should also determine whether an effective compliance program could be maintained under a revised withholding system.

Response

We agree to consider the feasibility of conducting such a study.

Recommendation (p. 88)

IRS needs to be able to issue deficiency notices after examination of each oil-producing property, without precluding later issuance of additional notices covering the producers' interest in other properties during the same quarter. To effect this procedure, we recommend that the Congress amend section 6212(c) of the Internal Revenue Code. A revised procedure has advantages for both the Service and taxpayers, including faster resolution of tax liability determinations.

Another windfall profit tax area which needs legislative action is the appeals process. We recommend that the Congress pass legislation to consolidate judicial appeals for a given property's "oil" issues. A consolidated appeals process would conserve both IRS and judicial resources, while also protecting taxpayers' rights. Precedent legislation is provided by Title IV of the Tax Equity and Fiscal Responsibility Act of 1982 which, among other matters, attempts to avoid duplicative judicial reviews of the tax treatment of partnership items.

Response

We agree with both the legislative proposal recommendations by GAO to Congress.

- The Service will propose legislation to Treasury to allow issuance of deficiency letters after examination of each property. A copy of the legislative proposal is attached.
- We will give close attention to the recommendation to improve the appeals process considering possible legislative initiatives to bring this improvement about.

INTERNAL REVENUE SERVICE--LEGISLATIVE PROPOSAL

ALLOW ISSUANCE OF DEFICIENCY LETTERS AFTER EXAMINATION OF EACH PROPERTY
WITHOUT PREVENTING FURTHER LETTERS AGAINST SAME PRODUCERSRecommendation

Amend section 6212(c) concerning further deficiency letters after a taxpayer has petitioned the Tax Court to allow a deficiency letter to be issued with respect to a producer's windfall profit tax in one or more properties without foreclosing the possibility of additional deficiency letters in subsequent years (as long as the statute of limitations remains open) with respect to that producer's windfall profit tax for the same taxable period in other properties. As indicated, not more than one deficiency letter per calendar year could be issued with respect to a given producer, although deficiency letters issued in different years could cover the same taxable period.

Present Law

Under section 6213, as amended by the Crude Oil Windfall Profit Tax Act of 1980, a taxpayer may petition the Tax Court for a redetermination of windfall profit tax deficiency. Thus, the windfall profit tax is unlike most other excise taxes, in that the Tax Court has jurisdiction over deficiency redeterminations.

Under section 4986, the producer is liable for the windfall profit tax. Under section 4996, the producer is defined as the holder of the economic interest with respect to the crude oil; in the case of a partnership that holds such an interest, individual partners are considered producers.

The windfall profit tax liability of a producer is affected by factors relevant to the producer's status (e.g., whether the producer is an independent or exempt producer) and by factors relevant to the property from which the oil is produced. For example, all oil from a given property will be classified as stripper oil (tier 2 oil) if the property had an average per well production of 10 barrels a day or less during a consecutive 12-month period. As another example, oil from a given property will be classified as heavy oil (tier 3 oil) if the weighted average gravity of oil from the well is 16 degrees API or less (corrected to 60 degrees Fahrenheit). The tier classifications are important in determining tax liability since tax rates and base prices vary by tier.

Under section 6212(c), as amended by the Crude Oil Windfall Profit Tax Act of 1980, if a notice of deficiency of windfall profit tax has been mailed to a taxpayer and the taxpayer has timely filed a petition with the Tax Court, no additional deficiency of windfall profit tax for the same quarter may be determined.

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Reasons for Change

Statistics of Income data indicate that the number of producers exceeds one million. (This figure will be refined as data becomes available from the Annual Windfall Profit Tax Information Return, Form 6248.) For any given property, there may be any number of holders of economic interests, i.e., producers. Some of the drilling funds or organized as partnerships have large numbers of partners (a few even exceeding 1,000 partners); for each economic interest in oil held by the partnership, each partner would be a producer. As this suggests, a person could be a producer in a large number of properties. These properties might be in the same general area or they could be widely dispersed in different parts of the country--in different IRS districts and regions--and the oil produced on these dispersed properties sold to different purchasers.

When facts bearing on the property--as contrasted to facts bearing on the producer (e.g., status as an independent producer)--indicate that too little windfall profit tax has been paid, generally all producers in that property will be affected. For example, if on a qualified tertiary recovery project an error by the operator resulted in too large a quantity of oil having been classified as incremental tertiary oil, all producers in that property will likely have underpaid their tax. Any one, or all, of the producers may wish to litigate the issue--some by paying the disputed tax and bringing the case to a U.S. district court or Court of Claims, and others by petitioning the Tax Court. As described above, the producer/petitioner may be a producer in other properties which may or may not have been considered in connection with a windfall profit tax examination.

Given the great number of oil producing properties and the great number of producers, some properties will be examined before other properties, and some producer returns (or returns deemed to have been filed if the producer is not required to file) will be examined before other returns. However, assertion of a deficiency with respect to one property interest of a producer would foreclose issuance of a subsequent notice covering that producer's interest in another property for the same quarter.

To ensure that the entire amount of any producer's windfall profit tax deficiency for a quarter is determined and covered in a statutory notice of deficiency before the statutory period has expired, a complex administrative system is necessary to track producers' interests and IRS actions with regard to these interests. Under this system, when it is determined, through examination at the property level, that an adjustment is necessary that would affect all producers on a particular property, immediate adjustments could be made only in agreed cases. In unagreed

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cases, the amount of adjustment per producer must be stored in a computer file until all of the properties in which that producer had an interest during the quarter have been examined and the results of those examinations and any subsequent appeals consolidated in the file. For each producer's interest in each property examined, a Statute Control Date must be determined and associated in the computer file with each adjustment. Because the running of the statute varies according to whether the oil is subject to withholding and, if subject to withholding, according to whether the producer is required to file a return, a Statute Control Date determination based on a producer's interest in one property (e.g., where the oil is subject to withholding) could be affected by a subsequent examination of the producer's interest in another property (e.g., where the oil is not subject to withholding). For example, assume producer A has an interest in property X, where oil is subject to withholding, and also has an interest in property Y, where the oil is removed before it is sold and, therefore, not subject to withholding. Assume producer A is a calendar-year taxpayer and files an income tax return on April 15. The Service examines property X and determines that not enough tax has been paid for the quarter ending June 30, 1980. The statute begins to run on producer A's interest in property X for that quarter on April 15, 1981. The Service subsequently examines property Y and determines that not enough tax has been paid for the quarter ending June 30, 1980. The statute begins to run on producer A's interest in property Y for that quarter when producer A files the quarterly return of windfall profit tax, by August 31, 1980. Since only one deficiency notice can be issued with respect to that producer's liability for the quarter, the Statute Control Date for producer A's interest in property X must be adjusted. Accurate, timely input of information into the computer file and monitoring of information in the file must be coordinated on a nationwide basis because many producers hold interests in properties in various IRS districts and regions.

The necessity of consolidating administrative action on the windfall profit tax liability of producers' interests in multiple properties for each taxable period is costly in terms of resources and possibly disadvantages revenue collection. Each time the Service determines that not enough windfall profit tax has been paid by producers with an interest in a particular property, it is faced with a choice: Should statutory notices be issued immediately, in which case collection of revenue (of a then undetermined amount) from other properties in which those producers have an interest would be foreclosed? Or should notices be suspended until other properties in which those producers have interests during the taxable period have been examined, in which case collection of revenue would be delayed (and possibly foregone, as a practical matter, in some cases)? Such a choice would be unnecessary if statutory notices could be issued covering producers' interests in a particular property

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during the taxable period. However, to avoid a great expansion in IRS' workload due to the potential increase in deficiency letter issuances (and the Tax Court's workload as well), no more than one letter would be issued per producer per calendar year. (Attached to this legislative proposal is an example illustrating the tax enforcement problems under current law.)

Many producers likely would welcome the legislative change since it would result in a faster resolution of their tax liability with respect to particular properties under examination. This also could result in considerable interest savings to them should the IRS position be sustained.

It is, therefore, recommended that the law be changed to allow the issuance of a statutory notice of deficiency covering a producer's net windfall profit tax liability with respect to a property for a taxable period without foreclosing the issuance of statutory notices in subsequent years covering that producer's windfall profit tax liability with respect to other properties for the same taxable period. Note that, under this proposal, these property-by-property statutory notices against producers would be allowed regardless of whether the issues affecting tax liability are "property" issues or "producer" issues.

Internal Revenue Service
Legislative Analysis Division
March 1982

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Attachment

The following example illustrates the tax enforcement problems under current law requiring a statutory notice to cover a producer's interests in multiple properties.

EXAMPLE

Producer X, an individual, has a working interest in two properties, property A and property B. X is an independent producer, with an income tax year ending November 30.

No windfall profit tax is withheld on X's interest in property A because the oil is removed from the premises before it is sold. On August 31, 1980, X timely files a windfall profit tax return for the second quarter of 1980. On this return, X shows that the oil in which he has an interest is tier 2 stripper oil—taxed at 30 percent because X is an independent producer. In December 1981, a Revenue Agent determines that the oil on property A is not stripper oil but is tier 1 oil—taxed at 50 percent for X, an independent producer. X does not agree with this determination. Appeals uphold the Revenue Agent's determination. The case is returned to Examination and placed in suspense. The case is removed from suspense on August 31, 1982, and a statutory notice of deficiency is sent to the taxpayer. The statute of limitations will expire on August 31, 1983—three years from the date X timely filed the windfall profit tax return.

Windfall profit tax is withheld by the first purchaser on X's interest in property B. Based on certification submitted by the operator that the oil on property B is tier 2 stripper oil, the first purchaser withholds at the 30 percent rate. Around March 31, 1981, X receives an annual information statement (Form 6248) from the first purchaser reflecting no underpayment or overpayment of windfall profit tax for 1980. Since X is not required to file a windfall profit tax return for the 1980 removal year, the return from which the statute runs is X's income tax return for fiscal year 1981 (the taxable year in which the removal year ends). Thus, the statute starts running March 15, 1982, and expires March 15, 1985. When the statutory notice of deficiency is sent on X's interest in property A (on August 31, 1982), there has been no examination of property B. Subsequent examination of property B results in a determination that the oil in which X had an interest in 1980 was not stripper oil but was tier 1 oil which should have been taxed at 50 percent for X, an independent producer. By the time this determination is made and the administrative process exhausted, a statutory notice has already been sent out on X's interest in property A for the second quarter of 1980. No other statutory notices can be sent out concerning X's windfall profit tax liability for that quarter, and the Government cannot collect the additional second quarter tax due on X's interest in property B.

If the law were changed to allow issuance of statutory notices with respect to a producer's interest in one property without foreclosing the possibility of issuing statutory notices with respect to that producer's interests in other properties during the same taxable period, a statutory notice could be issued on X's interest in property B.

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Alternatively, if the law were changed to provide for a single statute running date for a producer's interests during a taxable period (as recommended in another IRS legislative proposal), the Service could have waited in the above example to issue a statutory notice on X's interest in property A until it had sufficient time to accumulate information on X's interest in property B. The notice could then have covered X's entire windfall profit tax liability for the quarter. (Note that a statutory change providing for a single statute running date for a producer's interests during a taxable period would not be necessary if the law were changed to allow notices to be issued on a producer's interest in each property. A legislative change to allow notices to be issued on a producer's interest in each property is preferable administratively.)

APPENDIX II

APPENDIX II

EVOLUTION OF CRUDE OIL PRICE CONTROLS
AND THE WINDFALL PROFIT TAX ACT OF 1980

<u>Date</u>	<u>Action</u>
August 1971	President Nixon imposed a general price freeze on the economy for 90 days, under authority of the Economic Stabilization Act (12 U.S.C. 1904). The original freeze was followed by a "Phase II" designed to hold average annual price increases to no more than 3 percent generally in the economy.
January 1973	"Phase III" of the Nixon Administration's price controls began. Controls were mostly voluntary, except for the 24 largest oil companies with annual sales of \$250 million or more. Mandatory price controls for these companies continued through June 1973.
June 1973	Due to shortages of crude oil and refined products, a 60-day price freeze was imposed on all petroleum and refined products. The Cost of Living Council (CLC) was ordered to prepare comprehensive price control regulations for all phases of the petroleum industry.
August 1973	The CLC, as "Phase IV" of the Administration's price control program, issued comprehensive petroleum regulations. The CLC, through the regulations, promulgated a "two-tier" price control system, with production and pricing to be accounted for on a "property-by-property" basis. The final CLC regulations defined "property" as "the right which arises from a lease or fee interest to produce domestic crude petroleum." Also, the regulations defined "Base Production Control Level" (BPCL) for a given property as the level of production from the property in 1972. Under the CLC system, production from a property not exceeding the BPCL was termed "old" oil and was subject to a ceiling price.

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Production from the property that exceeded the BPCL was termed "new" oil and could be sold at market (uncontrolled) price. As an additional incentive to produce "new" oil, a producer could "release" a barrel of "old" oil from controls for each barrel of "new" oil recovered from a given property.

In short, the two-tier pricing system required a comparison of current production from a "property" to its BPCL in order to calculate the appropriate volumes of "old," "new," and "released" oil. This distinctive feature of crude oil price controls, with some modifications, has continuing significance today (for windfall profit tax purposes) even though President Reagan decontrolled crude oil prices in January 1981.

October 1973

The Organization of Petroleum Exporting Countries (OPEC) announced a crude oil embargo. The Arab oil embargo exacerbated the petroleum supply shortages experienced earlier in 1973.

Due to these events, new legislation emerged, the Emergency Petroleum Allocation Act of 1973 (EPAA), which directed the President to establish mandatory price and allocation controls on crude oil and refined petroleum products. (This Act was to expire by its own terms on August 31, 1975.)

December 1973

President Ford established the Federal Energy Office (FEO) to carry out the regulatory functions prescribed by the EPAA.

The FEO reissued, without substantive change, the Phase IV regulations in recodified form.

June 1974

The Federal Energy Administration (FEA) succeeded the FEO as the agency responsible for administering the EPAA-mandated controls.

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<u>Date</u>	<u>Action</u>
	FEA retained the two-tier system whereby "old," "new," and "released" oil were identified and priced according to the 1972 BPCL for each property in a producer's inventory.
December 1975	The Energy Policy and Conservation Act of 1975 (EPCA), Public law 94-163, extended and modified the price control provisions mandated earlier by the EPAA. The new act extended mandatory controls on crude oil through May 1979 and gave the President discretionary control authority through September 1981. Regarding substantive modifications, the new act imposed a "composite" price which could not be exceeded. Initially set at \$7.66 a barrel, the statutory composite price represented a weighted average of the price of all domestic crude oil. The resulting system of price controls can be summarized as follows: (1) previously uncontrolled "new" crude oil had a price ceiling, (2) "old" oil was categorized as either "lower tier" (being below an updated BPCL) or "upper tier" (production exceeding the updated BPCL).
August 1976	The Energy Conservation and Production Act (ECPA) of 1976, Public Law 94-385, removed stripper well oil from price controls.
September 1976	The FEA, under the Ford Administration, expanded the term "property" to recognize as separate properties "each separate and distinct producing reservoir subject to the same right to produce crude oil." The "separate-reservoir" concept, by design, increased the number of crude oil properties, and in turn, increased the opportunity to produce higher priced oil, i.e., "upper tier" oil.
April 1977	President Carter announced a National Energy Plan which included a proposed tax (Crude Oil Equalization Tax) to eliminate the difference between world market prices and the controlled prices of domestic crude oil. This proposed tax was not enacted by the Congress.

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April 1979

In an energy address to the Nation, President Carter announced his decision to gradually lift price controls on domestic crude oil, with full decontrol by October 1981. However, the President's decontrol program was conditioned upon congressional enactment of a "windfall profit tax." At this time, world crude prices were about \$30 a barrel, whereas domestically, controlled prices were about \$6 a barrel for "old" and \$13 for "new" oil.

April 1980

President Carter signed into law the "Crude Oil Windfall Profit Tax Act of 1980."

APPENDIX II

COMPLEXITIES OF THE WINDFALL PROFIT TAX (WPT) PROCESSTable 3Responsibilities of Crude Oil Owners, Operators, and
Purchasers Under the Windfall Profit Tax Act

Synopsis: The WPT liability is imposed on each producer (i.e., owner) of taxable domestic crude oil. Generally, the first purchaser computes and withholds the tax based on information furnished by the oil property operator and producers and deposits the tax with a Federal Reserve bank or authorized institution.

WPT	WPT Parties--Definitions and Responsibilities	
Parties	Definitions	Responsibilities
Producer	A producer is any person or entity which holds an economic interest in the crude oil in place in the ground.	The producer may certify to the purchaser (1) exemptions from the WPT and, as applicable, (2) whether the producer is an independent producer or an integrated oil company. Form 6458 may be used for these purposes.
Operator	This party manages and operates crude oil production from the property (i.e., pumps the oil).	Each month, the operator may furnish the purchaser the following certified information: (1) adjusted base price (see tables 5 and 6) (2) tier of the oil (see table 8) (3) amount of oil sold to the purchaser

APPENDIX III

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		(4) severance tax adjustment (see table 7) (5) An identification of the "property" from which the oil was produced.
Purchaser	Generally, the party responsible for withholding the WPT is the "first purchaser" of the crude oil after production. This may be a refinery, one of several companies which have historically gathered and marketed crude oil, or a broker or some other middleman.	The purchaser computes, withholds, and deposits the tax (see table 4). Also, the purchaser must (1) submit to IRS a Quarterly Excise Tax Return (Form 720) with a Form 6047 attached showing WPT computation data and (2) submit to producers and IRS annual summaries of WPT data (Form 6248).

Table 4Computation of the WPT for Withholding
and Deposit

Synopsis: The WPT is computed on each barrel of oil for each oil property.

Sale of 1 barrel oil (removal price)	\$30.00
Less: adjusted base price ^a	(19.17)
Less: severance tax adjustment ^b	<u>(1.08)</u>
Windfall profit ^c	<u>\$ 9.75</u>
Times WPT rate ^d	x 70%
Windfall profit tax withheld	<u>\$ 6.83</u>

Notes:

^aSee tables 5 and 6.

^bSee table 7.

^cBy law, the windfall profit may not exceed 90 percent of the net income attributable to each barrel of oil. However, this "net income limitation" is not considered at the time the WPT is withheld and deposited. Rather, the limitation is calculated after close of the taxpayer's income tax year within which the removal year (calendar year) ends and may result in a refund; see table 9.

^dThe WPT rate varies depending on the oil tier and the producer's status; see table 8.

Table 5Computation of Base Prices for WPT Purposes

	Base Price by Oil Tier for the Interim and Permanent Periods ^a	
WPT Oil Tier	Interim Rules: Applicable to crude oil removed from the premises during the period March 1, 1980 - September 30, 1980 ^b	Permanent Rules: Applicable to crude oil removed from the premises beginning October 1, 1980 ^c
Tier 1	Same as permanent rule.	The permanent base price for tier 1 is the May 1979 DOE ceiling price for upper tier crude oil reduced by 21 cents (about \$12.81 per barrel).
Tier 2	The interim base price for tier 2 oil is the December 31, 1979, highest posted price for uncontrolled oil of the same grade, quality, and field (or at the nearest domestic field where posted) multiplied by the fraction $\$15.20/\$35.00$. ^{d,e}	The permanent base price is the weighted average removal price per barrel of uncontrolled oil produced from the reservoir and sold by or for the taxpayer in uncontrolled sales during December 1979 multiplied by 0.42458.
Tier 3	The interim base price for tier 3 oil is the December 31, 1979, highest posted price multiplied by the fraction $\$16.55/\$35.00$. ^{d,e}	Same as the permanent rule for tier 2, except the multiplier is 0.46229.

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^aThe calculated base price for each tier further must be adjusted quarterly by an inflation factor. See table 6.

^bBecause of possible delays in promulgating Treasury regulations, the congressional conference committee decided to provide interim rules for computing the base price for tier 2 and tier 3 oil.

^cThe permanent rules are intended to achieve a base price that approximates the price at which the crude oil would have sold on December 31, 1979, if all domestic crude oil were uncontrolled and the average removal prices (other than Sadlerochit oil) were \$15.20 for tier 2 and \$16.55 for tier 3 oil.

^dFor this purpose, no price that was posted after January 14, 1980 will be considered. For a posted price to qualify for use in determining the interim base price for tier 2 or tier 3 oil, the price must be published in writing by a purchaser of a substantial volume of crude oil in the field. Not included are prices offered by a purchaser at amounts higher than prices posted by purchasers who buy most of the oil in a particular field. After the interim base price is established, no later adjustments are to be made for changes in grade or quality.

^eAdditionally, for tier 2 oil and tier 3 oil, minimum interim base prices are established. The minimum is the ceiling price that would have applied to the oil under March 1979 energy regulations if it had been produced and sold in May 1979 as upper tier oil, plus \$1.00 per barrel for tier 2 oil (\$2.00 for tier 3 oil). This provision is designed to partially lessen any inequities resulting from the interim base price computations.

Table 6Adjusting Base Prices for Inflation

	<u>WPT Oil Tier Classifications</u>		
	<u>Tier 1</u>	<u>Tier 2</u>	<u>Tier 3</u>
Base price before adjustment for inflation (assumed for illustration)	\$18.00	\$19.00	\$20.00
Times inflation adjustment factor for quarter ended September 30, 1980 ^a	<u>X 0.0649</u>	<u>X 0.0649</u>	<u>X 0.0810</u>
Inflation adjustment	<u>\$ 1.17</u>	<u>\$ 1.23</u>	<u>\$ 1.62</u>
Adjusted base price	<u>\$19.17^b</u>	<u>\$20.23</u>	<u>\$21.62</u>

^aInflation factors are based on the gross national product implicit price deflator; for tier 3 oil, an additional 0.5 percent per quarter compounded is included.

^bThis adjusted base price is used illustratively in tables 4 and 7.

Table 7Computation of Severance Tax Adjustment^a
on a Barrel of Crude Oil

Removal price ^b	\$30.00
Minus adjusted base price ^c	<u>(19.17)</u>
Portion of removal price entitled to severance tax adjustment	\$10.83
Times the state's severance tax rate ^d	X <u>10%</u>
Severance tax adjustment ^e	<u>\$ 1.08</u>

^aThe severance tax adjustment is that part of the removal price of a barrel of oil which Congress has exempted from the WPT. The adjustment is a deduction in computing the WPT and is the difference between the actual severance tax imposed with respect to a barrel of oil and the tax which would have been imposed had the oil been sold at its adjusted base price.

^bRemoval price is usually equivalent to selling price.

^cSee tables 5 and 6.

^dMost states which have crude oil resources impose a severance tax on either the value or quantity of resources extracted. The severance tax rates vary among the States.

To qualify as an adjustment in computing the WPT, each particular severance levy must meet four tests. First, the charge must be a "tax." Generally, a payment for some special privilege granted or services rendered would not qualify. Second, the tax must be imposed by a "State;" severance taxes imposed by political subdivisions (county, municipality, etc.) are disqualified. Third, the tax must be imposed on the "extraction" of oil. Hence, a tax levied on the value of reserves is not a severance tax. Fourth, the tax must be based on the "gross value" of extracted oil. That is, the tax must be determined on an ad valorem basis; a fixed tax rate of so many cents or dollars per barrel would not qualify.

^eSee table 4.

Table 8

Windfall Profit Tax Rates by Oil Tiers
and Producer Status
(Rates as Originally Enacted)

WPT Oil Tiers and Exempt Oil	Producer Status			
	Integrated oil company ^a	Independent producer ^b	Royalty owner ^c	Exempt producers ^d
	Windfall Profit Tax Rates			
Tier 1: Old oil ^e	70%	50%	70%	0%
Tier 2: Stripper oil National petroleum reserve oil	60%	30%	60%	0%
Tier 3: Newly dis- covered oil ^f Heavy oil Incremental tertiary oil	30%	30%	30%	0%
Exempt oil ^g	0%	0%	0%	0%

^aAn integrated oil company engages in all phases of the oil industry--exploration, production, transportation, refining, and retailing. As defined in the Crude Oil Windfall Profit Tax Act, a retailer is any taxpayer who directly (or through related persons) sells oil or natural gas (or any derived product) through retail outlets, provided that such sales exceed \$5 million in a calendar year. A refiner is any taxpayer engaged in the refining of crude oil directly or indirectly and has total refinery runs exceeding 50,000 barrels on any day in a calendar year.

^bThe reduced tax rates for an independent producer apply only to the first 1,000 barrels of oil per day of combined production of tiers 1 and 2 oil. Since independent producers account for a large portion of domestic exploratory drilling, Congress granted these producers special rates to encourage drilling activities. To qualify as an independent producer, the taxpayer must not be an oil or gas retailer or an oil refiner during the taxable period.

^cRoyalty owners include any owners of economic interests (in oil properties) that are defined as royalties for income tax purposes. This includes landowner royalties, overriding royalties, and net profits interests. Production arising from a royalty interest, or other nonoperating interests, is not eligible for the special reduced rates granted to independent producers. (Only production arising from working interests owned by independent producers qualifies for the reduced rates.) Generally, royalty owners are subject to the same WPT rates as integrated oil companies. However, royalty owners get one benefit not available to integrated oil companies--the benefit of claiming percentage depletion on the full price of the oil. Integrated oil companies, by statutory definition, do not qualify for percentage depletion.

^dThree categories of producers are exempt: (1) qualified governmental interests, (2) qualified charitable interests, and (3) certain Indian tribes, organizations, and individuals.

Production with respect to the economic interest in a property held by state and local governments is exempt if the net income from the property is dedicated to a public purpose.

Also exempt is production from properties owned on January 21, 1980, and at all times thereafter, by a qualified charitable educational or charitable medical facility. The Economic Recovery Tax Act of 1981 extended this exemption to oil production attributable to economic interests held by charitable entities organized and operated primarily for the residential placement, care, or treatment of delinquent, dependent, orphaned, neglected, or handicapped children.

The WPT Act also exempts oil production owned or received by Indian tribes, tribal organizations, and individual Indians over whom the United States exercises trust responsibilities from mineral interests held by or on behalf of Indian tribes or individual Indians on January 21, 1980.

^eThe WPT Act defines tier 1 oil by exclusion, i.e., tier 1 oil means "any taxable crude oil other than tier 2 oil and tier 3 oil." Generally, tier 1 oil will be production from an onshore property that had production in 1978, or production from Outer Continental Shelf leases entered into before January 1, 1979, provided the oil does not qualify as tier 2 or 3 oil.

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^fThe Economic Recovery Tax Act of 1981 provides for a gradual reduction of the windfall profit tax rate applicable to newly discovered oil, from the 30 percent rate applicable in 1980 and 1981, to a rate of 15 percent in 1986 and later years. Specifically, the tax rates will be as shown in the following table:

For taxable periods <u>beginning in</u>	Tax rate (percent)
1982	27.5
1983	25
1984	22.5
1985	20
1986 and later	15

⁹Four categories of oil are exempt: (1) exempt Alaskan oil, (2) exempt stripper oil, (3) exempt royalty oil, and (4) exempt front-end tertiary oil.

The Alaskan oil exemption includes oil produced from a reservoir that has been commercially exploited by a well located north of the Arctic Circle, other than oil from the Sadlerochit reservoir at Prudhoe Bay. Also included is oil produced from wells located north of the divide of the Alaskan and Aleutian mountain ranges if the well is at least 75 miles from the nearest point on the Trans-Alaskan Pipeline System.

The Economic Recovery Tax Act of 1981 exempts from the windfall profit tax, starting in 1983, stripper oil produced by independent producers. The exemption applies only if the oil is produced from a working interest owned by an independent producer.

For 1982 and later years, the Economic Recovery Tax Act also provides a limited exemption from the windfall profit tax for specified amounts of royalty production. In 1982 through 1984, royalty owners will be exempt from tax on two barrels a day per quarter of qualified royalty production. In 1985 and thereafter, three barrels a day of production per quarter will be eligible for the royalty owner exemption.

Additionally, front-end tertiary oil is either exempt from the windfall profit tax or, for nonexempt front-end oil, the tax is refundable to the extent allowed expenses are not recouped. Front-end oil is oil which DOE deregulated in connection with a program to encourage enhanced oil recovery projects by providing "front-end" financing. That is, under the program, certain

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oil was released from price controls if the additional revenue resulting from decontrol was used to finance a tertiary recovery project, e.g., natural gas may be injected in a reservoir to force more oil to the surface. There is no longer any front-end tertiary oil after decontrol of oil prices in January 1981.

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Table 9Computation of Net Income Limitation

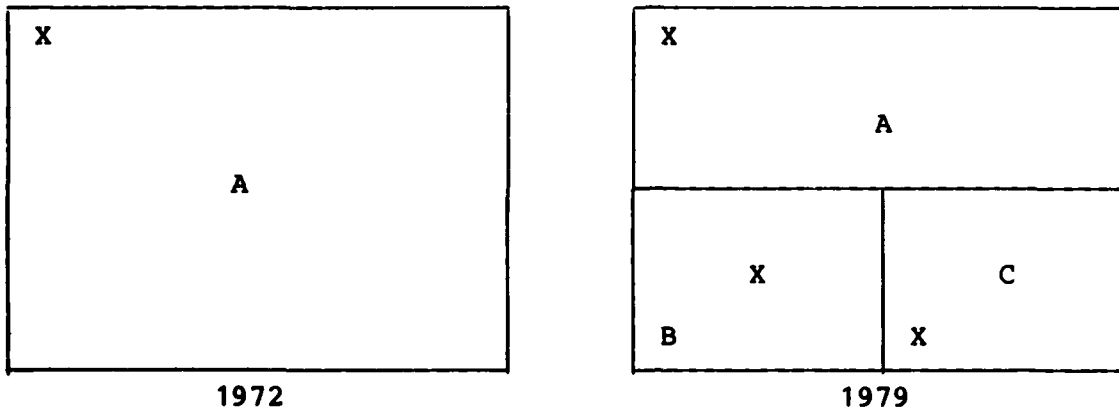
Sale of 1 barrel of oil (removal price)	\$30.00
Less: production costs ^a	<u>(23.33)</u>
Taxable income	<u>\$ 6.67</u>
Times net income limitation rate ^b	X <u>90%</u>
Net income limitation per barrel	<u>\$ 6.00</u>
Times WPT rate	X <u>70%</u>
WPT Liability based on 90% limitation ^c	<u>\$ 4.20</u>

^aVarious expenses may be taken into account in determining these costs. Certain costs may not be deducted, including the (a) WPT and (b) intangible drilling and development costs attributable to productive wells.

^bA single rate of 90 percent is provided by the WPT Act. By including such a provision in the act, the Congress wanted to preclude producers from incurring losses on crude oil production solely as a result of the WPT.

^cSince \$4.20 is less than the \$6.83 withheld (see table 4), the producer could claim a refund.

EXAMPLES OF HOW IMPROPER PROPERTY
DETERMINATIONS CAN LEAD TO WINDFALL
PROFIT TAX RATE ERRORS^a



^aAs of 1972, operator A was the lessee of a certain tract of land. Operator A had one producing oil well ("x") located in the northwest portion of the leased tract. This well has produced oil continuously since 1972. In 1979, operator A assigned to B the right to produce the southwest quarter and to C the southeast quarter. Subsequently, operators B and C each brought in a producing well ("x"). Generally, since property is defined as the right to produce as of 1972, there is still only one property. The 1979 assignments did not create separate properties.

Operators B and C might be classifying their production as newly discovered oil, which has a windfall profit tax rate of 25 percent for 1983. But, by definition, this oil cannot be newly discovered. For tax purposes, newly discovered oil is defined as oil produced from a property which had no production in 1978. In this example, the property did have production, i.e., from the well in the northwest portion of the property. Thus, oil from all three wells generally should be taxed as old oil, which has a windfall profit tax rate of 70 percent for integrated oil companies and 50 percent for independent producers.

Similarly, Operators A, B, and/or C might be certifying their production as stripper oil. But, again by definition, this oil generally cannot be classified as stripper unless the average daily production per well on the property did not exceed 10 barrels per day. The production from all three wells must be averaged in order to make that determination.

SUGGESTED AMENDMENT TO THE INTERNAL REVENUE CODE TO PROVIDE FOR
ISSUANCE OF NOTICES OF WINDFALL PROFIT TAX DEFICIENCIES BY
PRODUCER AND PROPERTY

Because the windfall profit tax on producers is calculated on a property-by-property basis, administration of the tax could be simplified if IRS were able to issue deficiency notices to producers on that same basis. Generally, a given producer will own an interest in more than one oil-producing property, and these properties may be examined by IRS agents at different times. However, section 6212(c) of the Internal Revenue Code provides that if IRS mails a notice of windfall profit tax deficiency to a producer-taxpayer, and the taxpayer then timely files a petition with the U.S. Tax Court for a deficiency redetermination, the Service cannot issue additional deficiency notices for the same taxable period with respect to this taxpayer. For this reason, IRS delays issuing windfall profit tax deficiency notices, until the applicable statute of limitations expiration date is near, in order to examine other properties and consolidate the deficiencies or adjustments of any producer having an interest in more than one property. This procedure has the effect of delaying revenue flows to the government and/or increasing taxpayers' interest costs. If the Congress were to amend the Internal Revenue Code in this regard, both the Service and taxpayers could benefit from faster resolution of tax liability issues.

Accordingly, we suggest that section 6212(c) of the Internal Revenue Code be amended to read, in part, as follows:

(1) General rule.--If the Secretary has mailed to the taxpayer a notice of deficiency as provided in subsection (a), and the taxpayer files a petition with the Tax Court within the time prescribed in section 6213(a), the Secretary shall have no right to determine any additional deficiency . . . of chapter 45 tax for the same property (as defined for oil tier determination purposes under section 4991) and the same taxable periods, except in the case of fraud, and except as provided in section 6214(a) (relating to assertion of greater deficiencies before the Tax Court), in section 6213(b)(1) (relating to mathematical or clerical errors), in section 6851 (relating to termination assessments), or in section 6861(c) (relating to the making of jeopardy assessments).

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In prescribing regulations under this section, the Secretary should limit the number of deficiency notices permitted to be issued to a taxpayer in a calendar year. In determining the reasonable and appropriate number of deficiency notices issued in a single calendar year to any one taxpayer, the Secretary should consider such factors as the paperwork burden on taxpayers and the need to maintain manageable workloads within IRS and the Tax Court.

SUGGESTED AMENDMENT TO THE INTERNAL REVENUE CODE
TO PROVIDE FOR CONSOLIDATED JUDICIAL REVIEW OF CERTAIN
WINDFALL PROFIT TAX ISSUES

The Tax Equity and Fiscal Responsibility Act of 1982 provides that partnership tax audits will be handled as if the partnership were a separate and distinct taxpayer. (26 U.S.C. §6231.) This should largely eliminate duplicative appeals, both administrative and judicial, of the same partnership items at issue. The new tax treatment also applies to partnership windfall profit tax items. (26 U.S.C. §6232.)

In our view, insofar as concerns a property's oil-related issues, windfall profit tax administration could be further simplified if the new appeals procedures were made applicable to all of the interest owners of an oil-producing property, in addition to partners and partnerships. IRS recently amended its regulatory rules to provide a consolidated administrative appeals procedure for "oil" issues, such as oil removal price, base price, and oil tier. These issues are not unique to an individual producer, but rather apply to all owners of oil from a given property. Under IRS' amended regulatory rules, all administrative appeals on these kinds of issues with respect to a given oil property would be held at the same time and, thus, would preclude duplicative appeals. However, legislation is needed to eliminate duplicative judicial appeals of these oil issues.

Accordingly, we suggest that section 6232 of the Internal Revenue Code be amended to read, in part, as follows:

(a) Inclusion as Partnership Item.

(1) In general - For purposes of applying this subchapter to the tax imposed by chapter 45 (relating to the windfall profit tax), the term "partnership item" means any item relating to the determination of the tax imposed by chapter 45 to the extent regulations prescribed by the Secretary provide that, for purposes of this subtitle, such item is more appropriately determined at the partnership level than at the partner level.

(2) Special rule.- To the extent and manner provided in regulations prescribed by the Secretary, any "oil item" shall be treated as a "partnership item" for purposes of applying the judicial review procedures of this subchapter to the tax imposed by chapter 45. An "oil item" shall be any such item the Secretary determines appropriate and necessary to the effective and efficient enforcement of this subtitle, regardless of whether a partnership as defined in this subchapter is involved in the tax imposed by chapter 45.

In prescribing regulations under this section, the Secretary should define "oil item" flexibly, permitting an exception to the consolidated appeals process for those producers who can demonstrate, for example, that certain oil-related items involve proprietary information and thus are better suited for individual determinations. The Service's recently amended regulatory rules for administrative appeals provide for such exceptions.



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

DEC 05 1983

Dear Mr. Anderson:

By letter of August 26, Commissioner Egger and I submitted comments with regard to your draft report entitled "IRS' Administration of the Crude Oil Windfall Profit Tax Act of 1980."

In the comment relating to the recommendation that the Secretary of Treasury should maintain three subaccounts in the Windfall Profit Tax account (recommendation on p. 13 of the draft report), we stated that maintenance of such subaccounts will be undertaken. However, I have been advised by the Fiscal Assistant Secretary of the Treasury that the Office of Management and Budget and the Treasury Department's Division of Government Accounts and Reports have determined that only one account is to be maintained under the statute. Accordingly, Treasury will continue its current practice of maintaining just one account for net windfall profit tax revenues.

Sincerely,



John E. Chapoton
Assistant Secretary
(Tax Policy)

Mr. William J. Anderson
Director, General Government Division
United States General Accounting Office
Washington, D.C. 20548

Enclosure

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