[JOINT COMMITTEE PRINT]

DESCRIPTION OF H.R. 3919: THE CRUDE OIL WINDFALL PROFIT TAX ACT OF 1979

AS PASSED BY THE HOUSE

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This pamphlet provides a description of H.R. 3919 (the "Crude Oil Windfall Profit Tax Act of 1979"), as passed by the House of Representatives on June 28, 1979.

The first part summarizes the provisions in the House bill. The second part explains the bill in detail. The third part shows the revenue effects of the bill.

I. SUMMARY OF THE HOUSE BILL

Overview

H.R. 3919, the "Crude Oil Windfall Profit Tax Act of 1979," (as passed by the House on June 28, 1979) imposes a 60-percent windfall profit tax on increases in domestic crude oil prices resulting from the deregulation of crude oil prices or from excessive increases in world oil prices. This tax would reduce the profits of oil producers and royalty owners; it would not be passed on as higher prices to consumers. Revenues from the tax would be placed in an energy trust fund to finance programs for dealing with the energy problem. Amounts in the trust fund would be available for purposes to be specified by law at a later date, subject to the usual authorization and appropriations process.

The tax would raise $3.7 billion in calendar year 1980, $7.7 billion in 1981 and $9.7 billion in 1982. In fiscal year 1980, the revenue raised would be $2.6 billion.

Windfall Profit Tax

The windfall profit tax is an excise, or severance, tax applying to all crude oil produced in the United States according to its classification in one of three tiers. Essentially, the tax structure is the same for the three tiers except that each tier has a different base price above which price increases are subject to tax.

Tier one tax

For oil in tier one, the tax is 60 percent of the difference between the actual selling price of the oil and the May 1979 lower tier, or old oil, ceiling price (which averaged just under $6 per barrel), adjusted for inflation.

The tier one tax applies to oil which would have been controlled as lower tier oil if the pre-June 1979 price controls had been continued but which receives a higher price as a result of decontrol. This tier does not include oil from "marginal" properties, which were given special treatment under the President's decontrol program.

The quantity of oil subject to the tier one tax on a property is the amount of production from the property below an amount represented by a statutory decline curve. This decline curve initially equals the average daily production of lower tier oil from the property in the period October 1978–March 1979. This base is reduced by 1½ percent per month beginning January 1979. This decline rate causes the tier one tax to phase out after June 1984. By July 1984, all of this oil will be taxed in tier two; that is, on price increases above the inflation-adjusted upper tier ceiling price, rather than the lower-tier ceiling price, which is the base for the tier one tax.

Tier two tax

The tier two tax is 60 percent of the difference between the actual selling price and the May 1979 upper tier, or new oil, ceiling price (which averaged just over $13 a barrel), adjusted for inflation. The tier two tax is to be phased out between November 1986 and the end of 1990 by increasing the tier two base price up to the tier three base price. After 1990, this oil will continue to be taxed in tier three.

The tier two tax applies to oil produced on a property in excess of the amount indicated by the tier one decline curve. Thus, the tier two tax base will include most oil which had been controlled as upper tier oil prior to the decontrol program (generally, oil discovered between 1972 and 1979) as well as oil released to tier two through the 1½-percent monthly decline curve. Because of the decline curve, increases in production on old properties resulting from additional drilling, secondary recovery or other methods generally would be taxed under the more lenient tier two tax. This tier also includes oil released from the lower tier to the upper tier of price controls to provide "front end financing" for tertiary recovery projects, and all production from "marginal properties." A property would qualify as being marginal if, for calendar year 1978, the average completion depth of all the property's producing wells and the average daily per well production from the property meet the following limits:

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

Tier three tax

The tier three tax applies to newly discovered oil, stripper oil, taxable Alaskan North Slope oil, oil produced on the Naval Petroleum Reserve (NPR) and incremental oil produced with qualified tertiary recovery methods. After 1990, all oil which was in tiers one and two also will be taxed in tier three.

The basic tier three rules apply to stripper oil, oil produced on the NPR and, after 1990, oil which was tiers one and two. This basic tier three tax is 60 percent of the difference between the actual selling price of the oil and $16 per barrel, adjusted for inflation and for differences in quality and location. Special rules apply to newly discovered oil. Alaskan North Slope oil, and incremental tertiary oil.

Newly discovered oil and incremental tertiary oil are taxed in tier three, but only to the extent the selling price exceeds a $17 base price (instead of $16). In addition, the first $9 of windfall profit on newly discovered or incremental tertiary oil is taxed at a 50-percent rate (instead of 60 percent), and the inflation adjustment to its base price and to the $9 of windfall profit eligible for the 50-percent rate is set 2 percentage points above the generally applicable inflation rate. The bill contains a more restrictive definition of newly discovered oil and a more liberal definition of incremental tertiary oil than the ones used for price controls. After 1990, newly discovered oil and incremental tertiary oil are exempt entirely.

Oil from the Sadlerochit reservoir in Alaska, which is the only North Slope reservoir now in production, is taxed in the third tier, but at a 50-percent rate (instead of 60 percent). The base price for

Sadlerochit oil is $7.50 per barrel (compared to an average wellhead price of $5.22 in 1978), adjusted upward for inflation and upward to the extent of any reductions in the real value of the Trans-Alaskan Pipeline System tariff. Oil from other Alaskan reservoirs located North of the Arctic Circle, including those already discovered but not yet developed, is exempt from the windfall profit tax.

Rules applicable to all three tiers

For oil subject to the 60-percent rate, the windfall profit subject to tax is reduced by the State severance taxes on the windfall profit.

To prevent the tax from burdening high-cost properties, the bill also limits the windfall profit subject to tax to 100 percent of the net income from a property.

Income from interests in oil production owned by State or local governments, or by public educational institutions, is exempt if the income is dedicated to public education.

The windfall profit tax is a deductible business expense under the income tax. In addition, gross income for purposes of determining percentage depletion is reduced by the amount of windfall profit.

The windfall profit tax also contains a number of provisions designed to aid taxpayers and the Internal Revenue Service in the administration and enforcement of the tax.

While the windfall profit tax is structured to be consistent with the proposed deregulation of crude oil prices, it is not contingent on decontrol and will apply even if some form of price controls were continued or reimposed.

Trust Fund

The revenues from the windfall profit tax are to be deposited in an Energy Trust Fund created by the bill. The purposes for which money may be spent from the trust fund will be specified in future legislation.

Effective Date and Study

The windfall profit tax is effective January 1, 1980. By January 1, 1983, the President is required to submit to Congress a study of the effects of both oil price decontrol and the windfall profit tax.

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II. DESCRIPTION OF H.R. 3919 AS PASSED BY THE HOUSE

A. Windfall Profit Tax

1. Overview of Price Controls

Old pricing regulations

Under the old crude oil price control regulations, which were superseded on June 1, 1979, by the President's phased decontrol program, there were essentially six categories of crude oil: lower tier oil, upper tier oil, stripper oil, Alaskan oil, oil produced on the Naval Petroleum Reserve, and incremental tertiary oil. Lower tier oil was controlled at an average ceiling price of about $6 per barrel. Upper tier oil was controlled at an average ceiling price of about $13 per barrel. Stripper oil was, and continues to be, statutorily exempt from all price controls. North Slope Alaskan oil, while technically in the upper tier, generally has sold below its ceiling price, so that it has been effectively uncontrolled. In addition, incremental tertiary oil and oil produced on the Naval Petroleum Reserve were exempt from controls.

Under both old and new price control regulations, the status of a particular barrel of oil depends on the property from which it is produced. A property, as defined under price control regulations, is either the right, arising generally from a lease or some other legal interest, to produce oil from a particular geographical area or any separate and distinct producing reservoir which the producer elects to treat as a separate property.

To determine the quantities of upper and lower tier oil on a property under the old regulations, a producer first determined the property's base production control level (BPCL). This BPCL equaled the lower of (1) 1972 average daily production of all oil on the property or (2) 1975 average daily production of old oil. If production declined between 1972 and 1975 and dropped below the BPCL after 1975, a producer subsequently could adjust his BPCL downward by applying the 1972–1975 decline rate. Also, if production was first above the BPCL and subsequently dropped below it, any shortfalls led to a "cumulative deficiency." On any property not exempt from controls, all production up to the level of the adjusted BPCL, plus any cumulative deficiency, was defined as lower tier oil; all remaining production was upper tier oil.

Stripper oil is any production from a property whose average production was less than 10 barrels per well per day for any consecutive 12-month period since 1972. Incremental tertiary oil is any production obtained from a property using qualifying tertiary recovery techniques that is in excess of an estimate of what the property could have produced using the best available nontertiary method.

New pricing regulations

The new Department of Energy (DOE) price regulations phase out these controls by September 30, 1981, when the legal authority to control oil prices expires; but for the interim period, several new categories of oil are established. Upper and lower tier oil are redefined, and there are special provisions for newly discovered oil, marginal properties, and "front end money" for qualifying tertiary recovery projects.

Under the new regulations, the lower tier ceiling price stays approximately where it was in May 1979, adjusted only for inflation. The upper tier ceiling price, starting January 1, 1980, will be raised on a path designed to take it to the world price by September 30, 1981, although the details of this path have not yet been set by final regulations.

Newly discovered oil was deregulated on June 1, 1979. This oil is defined as all production from an onshore property from which no oil was produced in 1978 or from an offshore lease entered into after December 31, 1978.

Under the new pricing regulations for properties which are not stripper, newly discovered, or marginal, producers will recompute their BPCLs for each property and adjust them in a manner designed to phase out the lower tier by October 1, 1981. The new BPCLs will equal the average production of lower tier oil in the six months ending March 31, 1979. Producers will adjust each BPCL downward by 1½ percent per month in 1979 and 3 percent per month in 1980 and the first 9 months of 1981. Starting on June 1, 1979, lower tier oil is defined as production below this new adjusted BPCL. The new regulations eliminate pre-June 1979 cumulative deficiencies, but a property's volume of upper tier oil is to be reduced by any cumulative deficiencies built up in the future.

The new pricing regulations will release marginal properties, defined according to average well depth and average production per well in 1978, to the upper tier more quickly. On June 1, 1979, the BPCL of a marginal property became 20 percent of its average production in the last six months of 1978; and on January 1, 1980, all oil from marginal properties goes to the upper tier. Also, on properties where approved tertiary recovery projects will be undertaken, additional quantities of lower tier oil may be released to the upper tier to provide "front end money."

All price controls are scheduled to expire after September 30, 1981.

2. Tier One

a. *Treatment under price controls*

Old pricing regulations.—Under DOE price control regulations as they stood prior to the President's decontrol program, lower tier oil generally was most oil produced on a property which first began production prior to 1973. Lower tier oil was, and continues to be, subject to a ceiling price equal to the sum of (1) the highest posted field price for that oil on May 15, 1973, (2) $1.35 per barrel, and (3) certain post-1975 increases intended to provide adjustments for inflation and to provide production incentives.

The volume of lower tier oil on a property was determined by computing a property's "base production control level" (BPCL). Oil production above this level was classified as upper tier oil and production at or below this level was classified as lower tier oil. Prior to recent regulatory changes, a property's BPCL was the lesser of (1) the average daily amount of all oil produced from the property in 1972, or (2) the average daily amount of lower tier oil produced from the property in 1975.

In the case of certain properties, the BPCL could be adjusted downward to project the 1972–1975 rate of production decline on the property. Under the DOE regulations in effect before June 1, 1979, downward adjustments to the BPCL worked as follows: if production from the property during the five-month period between February and July 1976 was less than the BPCL during that period, the property quualified for a downward BPCL adjustment beginning July 1, 1976. If upper tier oil was produced between February and July 1976, the property could not qualify for a downward adjustment to its BPCL until the first six-month period following the six-month period in which the property's total production fell below the BPCL. If the property qualified for a BPCL adjustment, the producer could reduce the BPCL every six months at a rate equal to the property's historic 1972–1975 decline rate. Otherwise, its BPCL remained constant. Oil actually produced in excess of the adjusted BPCL was classified as upper tier oil, and was entitled to receive the upper tier price.[1]

Decontrol Regulations.—Pursuant to regulations published by DOE on April 12, 1979, a producer may elect to have the BPCL for any prop-

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[1] Once a property had produced an amount of oil above its adjusted BPCL, if it subsequently produced an amount of oil below the level of its adjusted BPCL, the difference between the actual production and the adjusted BPCL resulted in a "cumulative deficiency." Before a property's production in excess of its adjusted BPCL could be classified as upper tier oil, any amount of oil by which the property fell below its BPCL for all prior months, *i.e.*, its cumulative deficiency, had to be eliminated or "paid back." A cumulative deficiency, however, can be eliminated through the DOE Exceptions Relief process by a showing that it was caused by force majeure.

erty be the average daily production of lower tier oil from the property for the six-month period ending March 31, 1979. For properties for which the producer elects to use this BPCL, the BPCL is reduced by 1.5 percent per month for 1979. The first such adjustment was effective as of June 1, 1979, and was calculated as if the adjustment had become effective January 1, 1979. Therefore, if an election was made for a property, its BPCL was reduced by 9 percent, effective June 1, 1979 (six months × 1.5 percent).

Effective June 1, 1979, the regulations eleminated all existing cumulative deficiencies. However, cumulative deficiencies may be built up in the future and will reduce the amount of oil eligible for the upper tier price.

On January 1, 1980, the BPCL decline rate will be increased from 1.5 percent to 3 percent per month. The 3-percent decline factor applicable to 1980 and 1981 will be available to all properties, including those electing not to use the updated BPCL and the 1½-percent decline rate in 1979.

The effect of the DOE pricing decline curve is to phase down the lower tier of price controls so that relatively little lower tier oil (19 percent of the original updated BPCL) will remain just before price control authority expires after September 30, 1981.

Marginal properties.—Under the DOE regulations published on April 12, 1979, oil produced from "marginal properties" would be established as a new classification of oil generally eligible to receive upper tier prices. Pursuant to these regulations, specific properties could qualify as "marginal." depending upon the average production level at different average well depths. A property would qualify as marginal if, for calendar year 1978, the average completion depth of all the property's producing wells and the average daily per production from the property met the following limits:

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

For pricing purposes, on June 1, 1979, the BPCL for a marginal property was reduced to 20 percent of the average daily production of lower tier oil from that property for the last six months of 1978, and the BPCL for marginal properties will be reduced to zero on January 1, 1980. Hence, after June 1, 1979, all production on a marginal property in excess of 20 percent of 1978 old oil production from the property can be sold at upper tier prices. On January 1, 1980, all oil from marginal properties will be eligible for the upper tier price.

b. *Oil in tier one of tax*

Virtually all oil taxed in tier one is oil which would have been lower tier oil for pricing purposes had the old pricing regulations been continued. However, some of the oil which would have been lower tier oil under the pre-June pricing regulations is taxed in a higher tier.

All production from certain kinds of properties is specifically exempt from tier one of the tax. These are stripper properties, properties producing newly discovered oil, marginal properties and properties located north of the Arctic Circle. Also, on certain properties which may have some oil taxed in tier one, some production on these properties may be automatically taxed in a higher tier. For example, oil released from the lower tier to the upper tier for pricing purposes to provide "front end financing" for tertiary recovery projects is taxed in tier two, and a certain volume of oil produced on properties on which the producer used qualifying tertiary recovery techniques is taxed in tier three.

Apart from these exceptions, the amount of oil on a property taxed in tier one will be all production up to an amount represented by a linear decline curve plus any cumulative deficiencies built up for tax purposes. The tier one decline curve will be the same as the decline curve used for phasing out the lower tier of price controls under the DOE regulations issued April 12, 1979, except that the monthly decline rate will be 1½ percent throughout the life of the tier one tax (i.e., until the 1½ percent curve reaches zero after June 1984), instead of accelerating to 3 percent after 1979. For tax purposes, producers will use the 1½-percent monthly decline rate even if they elect not to use the 1½-percent decline rate in 1979 for pricing purposes. (Under the new pricing regulations, if the producer elects the updated BPCL, he cannot use the 1½ percent decline rate in 1979.)

If total production on the property is less than the amount represented by the 1½-percent monthly decline curve plus any cumulative deficiency built up for tax purposes, all production on the property will be taxed in tier one. If production exceeds the sum of the decline curve and the cumulative deficiency, then an amount of production equal to the amount represented by the 1½-percent decline curve and the cumulative deficiency would be taxed in tier one, and remaining production would be taxed in tier two.

The cumulative deficiency used for tax purposes is the same as that used for pricing purposes except that it involves shortfalls in production below the 1½-percent tax decline curve, not the 3-percent pricing decline curve.

In the case of oil still controlled in the lower tier, it is expected that DOE will adjust lower tier ceiling prices so that they will always be equal to or less than the tier one adjusted base price, in which case there would be be no tier one tax on oil still controlled in the lower tier. (Decontrol of lower tier oil is being accomplished through the use of a special decline curve rather than through increases in the lower tier ceiling price, as discussed above.) However, should the DOE fail to do this, and should the lower tier ceiling price exceed the tier one adjusted base price on a particular property, some oil controlled in the lower tier for pricing purposes could be subject to the windfall profit tax on the (presumably small) gap between the lower tier ceiling price and the tier one adjusted base price.

c. *Base price and adjustments*

Oil subject to the tier one tax will have an initial base price, determined separately for each property, equal to the May 1979 ceiling price of lower tier oil from the property. May 1979 ceiling prices averaged about $5.86 per barrel. This base price would be adjusted quarterly for increases in the GNP deflator, but the inflation adjustment would be lagged by two quarters. Thus, the first inflation adjustment to the tier one base price would occur for the third quarter of 1979 (July–September) and would be based on the inflation which occurred between the last quarter of 1978 and the first quarter of 1979.[2]

d. *Tax rate and computation*

The windfall profit on a barrel of taxable crude oil included in the tier one base equals the difference between the actual selling price of the oil and the applicable inflation-adjusted base price. However, in computing the windfall profit on oil included in the tier one tax base, the windfall profit subject to tax may be reduced by the amount of any increase in the applicable State severance tax that results from the increased price of the oil over the adjusted base price; however, severance tax rate increases after March 1979 may not be taken into account. (For more detail on the severance tax adjustment, see section 8(d) below.) The windfall profit tax on oil in tier one is 60 percent of the difference between the selling price and the sum of the adjusted base price and the severance tax adjustment.

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[2] More precisely, if B_o=the May 1979 lower tier ceiling price on a property and P_i=the GNP deflator in the ith quarter, the adjusted base price in the ith quarter is

$$B_i=B_o\left(\frac{P_{i-2}}{P_{1978.4}}\right)$$

3. Tier Two

a. *Treatment under price controls*

Under DOE regulations, upper tier oil is the amount of oil produced from a property in excess of its adjusted BPCL, less the amount of any cumulative deficiency. This includes all production from properties which first began production after 1972. However, it does not include oil produced from a stripper well property, oil classified as newly discovered, or incremental production from a qualified tertiary enhanced recovery project.

The DOE regulations published on April 12, 1979, established oil produced from "marginal properties" as a new classification of oil generally eligible to receive upper tier prices (see description of marginal properties in section 2(a) above). In addition, the Administration has announced its intention to release an unspecified amount of lower tier oil to the upper tier price to provide front end money for the financing of tertiary recovery projects.

Generally, the ceiling price for upper tier oil from a property is the highest posted field price for uncontrolled oil on September 30, 1975, less $1.32 per barrel, plus certain post-1975 increases intended to offset inflation. (EPCA required a rollback of the upper tier ceiling price.) The estimated average May 1979 ceiling price per barrel of upper tier crude oil was $13.06.

The Administration has announced its intention to allow upper tier prices to increase, in equal monthly increments, to the world price between January 1, 1980, and October 1, 1981.

b. *Oil in tier two of tax*

The oil included in tier two of the tax generally will be (1) oil production on a property in excess of the amount represented by the 1½-percent monthly decline curve (minus any cumulative deficiency built up for tax purposes) (2) oil produced from marginal properties, and (3) oil released from the lower tier to the upper tier for pricing purposes to provide "front end financing" for tertiary recovery projects. This tier includes oil discovered after 1972, because that oil will have a BPCL of zero. All oil on stripper properties, newly discovered oil, and oil produced north of the Arctic Circle is specifically exempt from tier two. Also, on properties using tertiary recovery techniques, a certain volume of oil will be released from tiers one and two to tier three (discussed below in section 6). Tier two merges into tier three after December 31, 1990.

c. *Base price and adjustments*

The base price for oil included in tier two is the May 1979 ceiling price of upper tier oil for each property. May 1979 ceiling prices averaged about $13.06 per barrel. This base price, with respect to which any windfall profit is measured, is adjusted quarterly for increases in the GNP deflator in exactly the same manner as the tier one base price.

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The tier two tax is to be phased out between November 1986 and the end of 1990 by increasing the tier two base price up to the tier three base price. The precise adjustments are to be determined under Treasury regulations.

d. *Tax rate and computation*

The windfall profit subject to the tier two tax is any amount by which the price of a barrel of oil exceeds its adjusted base price. In computing the tax base, producers may reduce the windfall profit by the amount of any State severance tax attributable to the increase in price of the barrel of oil over the adjusted base price; however, severance tax rate increases after March 1979 cannot be taken into account for this adjustment. (For more detail on the severance tax adjustment, see section 8(d) below.) The windfall profit tax on oil in tier two is 60 percent of the difference between the selling price and the sum of the adjusted base price and the severance tax adjustment.

4. Tier Three—Stripper Oil and General Rules Applicable After 1990

Tier three consists of several categories of oil which are not now subject to effective price controls. These categories include: (1) oil produced from stripper well properties, *i.e.*, those properties where the average daily production per well has been 10 barrels or less per day during any consecutive 12-month period after 1972, (2) certain production from properties where the producer used qualifying tertiary recovery methods, (3) "newly discovered oil" which is sold on or after June 1, 1979, (4) oil produced from the Sadlerochit reservoir in Alaska and (5) oil produced on the Naval Petroleum Reserve.[3] In addition to the five categories of oil initially in tier three, all tier one and tier two oil will be taxed in tier three after December 31, 1990, when tier two is merged into tier three. This section deals with stripper oil and with the general tier three rules applicable to all taxable oil produced after 1990. Newly discovered oil is discussed in section 5, incremental tertiary oil in section 6, and Sadlerochit oil in section 7.

a. *Treatment under price controls*

The Trans-Alaska Pipeline Authorization Act initially provided a statutory exemption from price controls for the first sale of crude oil produced from stripper well leases. This provision was modified several times before the Energy Conservation and Production Act provided the present exemption from price controls for stripper oil. To qualify for this exemption, a property's average daily per well production of crude oil (excluding a condensate recovered in non-associated production) must have been 10 barrels or less per day during any consecutive 12-month period beginning after December 31, 1972.

To qualify under the stripper exemption a property must be operated at the maximum feasible rate of production and in accordance with recognized conservation practices. However, once a property has qualified as being within the exemption, it retains that status regardless of any future increase in the level of its production.

b. *Oil in tier three of tax*

The tier three tax base generally includes all newly discovered oil, stripper oil, oil produced from the Sadlerochit reservoir in Alaska, and certain oil produced on properties on which the producer uses qualifying tertiary recovery techniques. Also, after 1990 tier three in-

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[3] Production from the Naval Petroleum Reserve is owned by the United States, as is oil production from various other Federal enclaves. Production from the Naval Petroleum Reserve is not subject to price controls and, therefore, is subject to the tier three tax. Any windfall profit tax imposed on this oil would be deposited into the energy trust fund. These tax revenues would not change the Federal unified budget deficit because the government would, in effect, be paying a tax to itself. The revenue estimates in part III of the pamphlet ignore any tax revenue from the NPR or from Federal royalties.

cludes all oil which would otherwise have been in tier two but for the phaseout of tier two. Special rules, discussed below in sections 5, 6 and 7, apply to newly discovered oil, incremental tertiary oil and Sadlerochit oil. The basic rules of tier three, therefore, apply only to oil produced from stripper properties and, after 1990, to the oil which would have been in tier two.

Stripper oil.—Stripper oil is oil produced on properties on which the average daily production per well has been 10 barrels or less for any consecutive 12-month period after 1972. All oil which qualifies for stripper treatment under the standards of the price control regulations in effect on June 1, 1979, is included in tier three. However, there is one exception relating to cases in which a nonstripper property is divided into several properties and one or more of the new properties qualifies as a stripper property for pricing purposes. If the entire property would not have qualified for stripper treatment prior to the transfer, then none of the subdivisions are eligible for the tier three tax, and they must instead follow the general tier one and tier two rules. (See section 8(b) for a discussion of the transfer rule.)

c. *Base price and adjustments*

The base price for oil included in tier three generally is the estimated price, to be prescribed by Treasury regulations, at which uncontrolled crude oil of the same grade, quality, and location would have sold in December 1979 if the average landed price for imported crude oil were $16.00 a barrel. This base price is adjusted for inflation, with the first adjustment occurring in the first quarter of 1980 based on inflation between the second and third quarters of 1979.[4] The windfall profit is the difference between the selling price and the sum of the adjusted base price and the severance tax adjustment. Use of this variable $16.00 formula is intended to take quality and location differentials into account in measuring the windfall profit. The Secretary of the Treasury will publish a schedule of tier three base prices for various classifications of oil based on quality, grade and location differentials.

d. *Tax rate and computation*

Except as provided in the case of newly discovered oil, incremental tertiary oil, and Sadlerochit oil, which are accorded preferential windfall tax treatment, the windfall profit on a barrel of crude oil included in the tier three tax base is subject to a 60-percent tax. The amount of the windfall profit may be reduced by the amount of any State severance tax attributable to an increase in the price of the barrel of oil sold over the adjusted base price; however, increases in tax rates after March 31, 1979, are not taken into account.

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[4] More precisely if B_0=the base price on a property and P_i=the GNP deflator in the ith quarter, the adjusted tier three base price is

$$B_i=B_0\left(\frac{P_{i-2}}{P_{1979.2}}\right)$$

5. Tier Three—Newly Discovered Oil

a. *Treatment under price controls*

Under regulations published on May 2, 1979, "newly discovered oil" is defined as crude oil which is sold after May 31, 1979, and which is produced from (1) an outer continental shelf area for which the lease was entered into on or after January 1, 1979, and from which there was no production in calendar year 1978, or (2) an onshore property from which no crude oil was produced in calendar year 1978. Oil produced from a property, as defined by DOE regulations, which previously had been developed but from which there was no production in calendar year 1978 is treated as newly discovered oil under this definition. The determination of whether crude oil production from a particular property may be sold as newly discovered crude oil on or after June 1, 1979, is to be made by the producer, subject to DOE's possible review.

Newly discovered oil sold after June 1, 1979, is exempt from price controls.

b. *Definition*

For windfall profit tax purposes, the term "newly discovered oil" generally has the same meaning given to that term by DOE's May 2, 1979, regulations. However, not all oil which could qualify as being newly discovered under the DOE regulations can qualify as being newly discovered for windfall profit tax purposes. Oil produced from a property, as defined by DOE regulations, which produced any oil in commercial quantities after 1969 and prior to 1979 does not qualify as being newly discovered for windfall profit tax purposes. (The pricing definition requires only that there was no production in 1978.)

In addition, the term "newly discovered oil" does not include oil produced from a reservoir on any tract or parcel of land if the reservoir was penetrated after 1969 and prior to 1979 by a well on that tract or parcel from which oil was produced in commercial quantities if oil could have been produced from the penetrated reservoir through that well prior to 1979. This rule is called the "behind-the-pipe" exclusion. It applies if oil could have been produced from the penetrated reservoir through the penetrating well prior to 1979 by taking whatever appropriate completion measures, *e.g.*, perforating the pipe, would have been necessary to obtain production from that reservoir. The behind-the-pipe exclusion applies only to production from the tract or parcel on which the original producing well which penetrated (and bypassed) the reservoir was located; it does not apply to wells located on new tracts or parcels which did not produce between 1969 and 1979. For example, the behind-the-pipe exclusion from the definition of newly discovered oil would not apply if a producer obtained production from a reservoir which has been penetrated by another producer from the latter's property.

Also, when a property which does not qualify for treatment as newly discovered oil is divided into several new properties, production from any of the new subdivisions does not qualify as newly discovered oil.

c. *Base price and adjustments*

The base price for newly discovered oil is to be determined in the same manner as that applicable to tier three oil generally except that it is to be $1 higher. Thus, the base price is to be that price at which uncontrolled crude oil of the same grade, quality, and location would have sold in December 1979 if the average landed price for imported crude oil had been $17 a barrel.

The adjusted base price for newly discovered oil is to be determined by adjusting the base price quarterly for net increases in the GNP deflator multiplied by 1.005^n where n equals the number of calendar quarters beginning after September 1979 and before the calendar quarter in which the oil is removed, or deemed removed, from the premises. (Thus, "n" will be 1 in the first quarter of 1980, 2 in the second quarter, etc.) This has essentially the same effect as adjusting the base price for newly discovered oil by the rate of inflation plus 2 percent annually, with the 2-percent compounded quarterly.[5] This special inflation adjustment also applies to the $9.00 amount which measures the windfall profit on any barrel of newly discovered oil subject to the 50-percent rate.

d. *Tax rate and computation*

The windfall profit on a barrel of newly discovered oil is the amount by which the price of the barrel of oil exceeds its adjusted base price. The first $9.00 of windfall profit, as adjusted by the special inflation adjustment, including the 2-percent add-on, is subject to a 50-percent windfall profit tax rate; increases above that adjusted amount are subject to the generally applicable 60-percent windfall profit tax rate.

The windfall profit on a barrel of newly discovered oil may be reduced by the amount of any additional severance tax imposed with respect to the barrel as a result of price increases above the base price plus $9, as adjusted for inflation and the 2-percent kicker. Severance tax rate increases after March 1979 are not taken into account. Thus, no deduction for severance taxes is allowed with respect to the windfall profit which is subject to a 50 percent tax rate, but the adjustment is allowed for that part of the windfall profit taxed at 60 percent.

Newly discovered oil is exempt if produced after December 31, 1990.

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[5] More precisely, if B_o is the base price for oil from a property and P_i is the GNP deflator in the ith quarter, the adjusted base price in the ith quarter (B_i) is given by

$$B_i = B_o \left(\frac{P_{i-2}}{P_{1979.2}} \right) 1.005^i$$

6. Tier Three—Incremental Tertiary Oil

a. *Treatment under price controls*

Under DOE regulations, first sales of incremental crude oil resulting from the implementation or expansion of a "qualified tertiary enhanced recovery project" are exempted from the otherwise applicable ceiling price limitations. A qualified tertiary enhanced recovery project is one certified by DOE as being uneconomic at the otherwise applicable ceiling prices, and which involves one or more of several specified chemical, fluid or gaseous recovery techniques.

Generally, incremental tertiary production is the amount of production on a property, on which a qualifying project is being undertaken, in excess of an estimate of what production would have been without the tertiary project. The estimate of what production would have been without the project must be done as a case-by-case basis.

b. *Definition*

For tax purposes, incremental tertiary oil is the amount of production from a property on which the producer uses a qualified tertiary recovery method in excess of a base level amount for the property. Unlike the case-by-case determination of the base level required under price controls, the tax uses a statutory decline curve to measure the base level production.

Specifically, the base level is the average daily amount of oil removed from the property during the six-month period ending March 31, 1979, reduced by the sum of (1) 1 percent of that average for each month beginning after 1978 and before the beginning date of the project, and (2) 2½ percent for each month thereafter. However, if DOE, in connection with its case-by-case deregulation of incremental tertiary production, determines that the incremental production resulting from the tertiary project exceeds the amount in excess of this statutory decline curve, then the larger amount deregulated by DOE qualifies for tier three. If a certification is obtained from DOE prior to the effective date of the tax, the 2½-percent decline rate may be used for all months subsequent to the commencement or expansion of the project (or, if the project began before 1979, all months subsequent to December 1978) if that decline curve is more favorable than the one determined by DOE.

If a qualified tertiary recovery project affects only a portion of a property, that portion is to be treated as a separate property. Similarly, if a preexisting tertiary recovery project is expanded significantly, the expansion is to be treated as a separate project. If a project affects more than one property, the base level is to be computed with respect to all of the affected properties under the rules generally applying to unitized properties. In determining the base level with respect to which the incremental production from a tertiary recovery project is measured, therefore, it may be necessary to allocate the base level of a single property or to combine the base levels of more than one property.

If the tertiary project is discontinued, oil production from the property is no longer eligible for tier three treatment under this provision.

The project's beginning date after which the $2\frac{1}{2}$-percent decline rate starts is that point at which the tertiary method significantly affects the reservoir. Thus, the project is considered to have commenced when significant use of the relevant tertiary process or injection begins; mere preparation or planning for the tertiary process, such a drilling an injection well, or use of the tertiary method on a pilot basis, is not sufficient to establish the project's beginning date. This beginning date may be a few months before the tertiary process actually begins to increase production.

Before the tier one decline curve has phased out in July 1984, producers using qualifying tertiary methods will have to calculate two decline curves: the generally applicable $1\frac{1}{2}$-percent tier one decline curve based on the production of lower tier oil in the six-month period ending March 31, 1979, and the 1-percent/$2\frac{1}{2}$-percent tertiary decline curve based on production of all oil on the property in that period. Producers will first calculate how total production would have been divided between tiers one and two in the absence of any special rules for tertiary projects, using the $1\frac{1}{2}$-percent decline curve. Then they will use the special tertiary decline curve to measure how much oil will be released to tier three. The oil released to tier three comes pro rata from oil which would have been in tiers one and two. To determine exactly which barrels from tier one and tier two are released to tier three, the producer first releases oil from each tier in order of its removal price, starting with the barrel with the highest selling price.

Qualified tertiary projects.—For purposes of the windfall profit tax, a qualified tertiary recovery project is either (1) a project with respect to which a DOE certification is in effect for pricing purposes, or (2) a project for the tertiary recovery of oil which meets specified requirements. In either event, the preferential windfall profit tax treatment for the incremental tertiary production continues only so long as the DOE certification is effective or the project continues to meet the tax's requirements. (After price control authority expires on September 30, 1981, a DOE certified project will have to continue in operation to retain the preferential windfall profit tax treatment.) If a DOE certification is not in effect, a project may qualify if it meets the following specifications: (1) it involves the application of one or more tertiary recovery methods, (2) the methods are applied in accordance with sound engineering principles, (3) the application of the tertiary recovery methods can reasonably be expected to result in a significant increase in the amount of oil which ultimately will be recovered from the property, or the project area, above the amount which reasonably could be expected to be recovered in the absence of the project, (4) the project could not be expected to be economic without the preferential tax treatment; (5) the project's beginning date is after May 1979, and (6) the operator submits to the Secretary such information, forms, and certifications as may be required by regulations.

This procedure of allowing producers to certify their own qualified tertiary recovery projects, subject to IRS audit, was intended to reduce the red tape associated with the certification procedure used under price controls, in which advance approval from DOE is needed.

Production from a tertiary recovery project will not be accorded preferential windfall profit tax treatment if the producer uses the project merely as a method of accelerating (as opposed to increasing) the total amount of oil expected to be recovered from the property or project area. An increase in the amount of oil expected ultimately to be produced would not be considered significant if the revenue from the increased production were not sufficient to cover the costs of the project at expected world oil prices. The requirement that the tertiary project be expected to increase production from the property could be satisfied by showing that the project would reduce the decline in production significantly below what it would otherwise be; that is, an actual increase in production over earlier levels is not necessary. In addition, the House Committee Report states that the requirement that the project would be uneconomic without the preferential tax treatment is to be construed liberally in favor of qualifying tertiary projects. For example, the calculation of whether a project is economic should take into account the high rate of return which must be expected to justify an investment in a new or risky technology.

To qualify the incremental production from a teritary recovery process for inclusion in the tier three tax base, the operator must submit to the Secretary a certification from a petroleum engineer that the project meets, and continues to meet, all the necessary requirements, and continues to involve use of an approved method in a sound manner, as well as any other information which the Secretary may require by regulations. The certification submitted by the operator must include the specifications of the project, including the tertiary methods to be applied, an identification of the area to be affected, supporting geological and engineering data, and other information sufficient to establish that all requirements for a qualified tertiary enhanced recovery project are satisfied.

For windfall profit tax purposes, a tertiary recovery method is any of the following: (1) miscible fluid displacement, i.e., the pressurized injection of alcohol or gas so that the reservoir oil is diplaced by the resulting mixture, (2) steam drive injection, (3) microemulsion, i.e., an augmented water flooding technique, (4) in situ combustion, (5) polymer augmented waterflooding, (6) cyclic steam injection, (7) alkaline flooding, (8) carbonated waterflooding, and (9) immiscible carbon dioxide displacement.

In addition, the Secretary is authorized to approve other tertiary enhanced recovery methods.

c. *Base price and adjustments*

The base price for incremental tertiary oil is to be determined in the same manner as that applicable to tier three oil generally except that it is to be $1 higher. Thus, the base price is to be that price at which uncontrolled crude oil of the same grade, quality, and location would have sold in December 1979 if the average landed price for imported crude oil had been $17 a barrel.

The adjusted base price for incremental tertiary oil is to be determined by adjusting the base price quarterly for net increases in the

GNP deflator multiplied by 1.005^n where n equals the number of calendar quarter beginning after September 1979 and before the calendar quarter in which the oil is removed, or deemed removed, from the premises. (Thus, "n" will be 1 in the first quarter of 1980, 2 in the second quarter, etc.) This has essentially the same effect as adjusting the base price for incremental tertiary oil by the rate of inflation plus 2 percent annually, with the 2-percent compounded quarterly.[6] This special inflation adjustment also applies to the $9.00 amount which measures the windfall profit on any barrel of incremental tertiary oil subject to the 50-percent rate.

d. *Tax rate and computation*

The windfall profit on a barrel of incremental tertiary oil is the amount by which the price of the barrel of oil exceeds its adjusted base price. The first $9.00 of windfall profit, as adjusted by the special inflation adjustment, including the 2-percent add-on, is subject to a 50 percent windfall profit tax rate; increases above that adjusted amount are subject to the generally applicable 60-percent windfall profit tax rate.

The windfall profit on a barrel of incremental tertiary oil may be reduced by the amount of any additional severance tax imposed with respect to the barrel as a result of price increases above the base price plus $9, as adjusted for inflation plus the 2-percent kicker. Severance tax rate increases after March 1979 are not taken into account. Thus, no deduction for severance taxes is allowed with respect to the windfall profit which is subject to a 50 percent tax rate, but the adjustment is allowed for that part of the windfall taxed at 60 percent.

Incremental tertiary oil is exempt if produced after 1990.

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[6] More precisely, if B_0 is the base price for oil from a property and P_i is the GNP deflator in the ith quarter, the adjusted base price in the ith quarter (B_i) is given by

$$B_i = B^o \left(\frac{P_{i-2}}{P_{1979.2}} \right) 1.005^i$$

7. Tier Three—Alaskan Oil

a. *Treatment under price controls*

Oil produced from wells located north of the Arctic Circle, like most other domestic production from a property which commenced production after 1972, is permitted to be priced at the upper tier ceiling price under existing DOE price regulations applicable to the first sale of domestic crude oil. Although technically it is controlled as upper tier oil, oil produced from wells located north of the Arctic Circle sells at a market price below its ceiling price. In 1978, when the price of uncontrolled stripper oil was $14 per barrel and Alaska's upper tier ceiling price was about $12 per barrel, Alaskan oil sold for $5.22 per barrel at the wellhead. Basically, Alaskan oil sells at a wellhead price below its ceiling price because of the large costs involved in transporting the oil to the market and because purchasers will pay no more for oil which is subject to high delivery costs than they will for oil which is not subject to such charges. Thus, for example, if a producer can purchase a locally produced barrel of oil for $18, including delivery fees, he generally would not pay the same amount, plus about $8 in transportation charges, for Alaskan oil. As a result, the amount paid at the refinery gate for Alaskan oil must be reduced by the transportation charges to arrive at the producer's wellhead price, which in this example would be $10.

b. *Definition*

The windfall profit on a barrel of oil from the North Slope reservoir from which oil production occurred in 1979, *i.e.*, the Sadlerochit reservoir, is subject to tax under special rules. Production from other reservoirs located north of the Arctic Circle is not subject to tax.

c. *Base price and adjustments*

The base price for Sadlerochit oil initially is $7.50 and is to be adjusted by the inflation factor generally applicable for adjustments to oil included in tier three (other than newly discovered and incremental tertiary oil).

The adjusted base price for Sadlerochit oil is to be adjusted further for changes in the real value of the Trans-Alaskan Pipeline System tariff from its 1978 level of $6.26 per barrel (*i.e.*, the extent to which the TAPS tariff in a particular quarter, adjusted for inflation, is less than its value in 1978). The TAPS adjustment, which may not be negative, for any calendar quarter is the excess, if any, of $6.26, adjusted for inflation, over the TAPS tariff for the preceding quarter. The TAPS tariff for the preceding quarter is the weighted average per barrel amount paid by all the producers for transportation of crude oil through the TAPS ending in that quarter (including pipeline liability charges). The inflation adjustment by which the $6.26

figure is increased is identical to that which is generally applicable to oil included in tier three except that it uses the price level in the second quarter of 1978 for its base.[7]

The windfall profit subject to tax on the sale of Sadlerochit oil by any producer is the amount by which the average removal price of a barrel of that producer's oil during the month exceeds the adjusted base price of oil from the property. The average wellhead price for each producer is used in lieu of the actual sale price of each particular barrel of oil to make sure that wellhead price differentials attributable only to the final destination of a particular barrel of Alaskan oil do not affect windfall profit tax liabilities. (Unlike other oil, North Slope oil produced from the same reservoir at the same time can have different wellhead prices depending on the final destination of the oil because each integrated producer determines the wellhead price for each individual barrel by subtracting transportation costs for that barrel from the price of the oil at the refinery gate.)

d. *Tax rate and computation*

The windfall profit on a barrel of Sadlerochit oil is the amount by which the average wellhead price exceeds its adjusted base price. No reduction in the windfall profit is allowed for State severance tax because the oil is subject to a special 50-percent tax rate. For purposes of computing the windfall profit, a producer's selling price is his average weighted selling price for Sadlerochit oil in a particular month, rather than the actual per barrel selling price. The difference between this figure and the adjusted base price is subject to a 50 percent tax.

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[7] More precisely, the adjusted base price for Sadlerochit oil is determined as follows: If Pi is the GNP deflator in the ith quarter and Ti is the average TAPS tariff in the ith quarter, the adjusted base price for Sadlerochit oil is

$$B_i = 7.50\left(\frac{P_{i-2}}{P_{1979.2}}\right) - T_i + 6.26\left(\frac{P_{i-2}}{P_{1978.2}}\right)$$

8. Special Rules and Definitions Applicable to All Tiers

a. *Definition of "property"*

For windfall profit tax purposes, the word "property" has two different meanings. Generally it has the same meaning as that term is given by the price control regulations. "Property," therefore, generally means either (1) a right to produce domestic crude oil which arises from a lease or fee interest, or (2) at the election of the producer, separate and distinct producing reservoirs which are subject to the same right to produce and which are recognized as separate and distinct reservoirs by the appropriate government regulatory authority.

However, in some cases the word "property" has the meaning given to it in section 614 of the Code, which generally does not allow a producer to elect to treat separate reservoirs on a single tract or parcel of land as separate properties. In the bill, this tax definition of the term property is used in reference to percentage depletion and to the 100-percent-of-net income limit on the taxable windfall profit.

b. *Property transfers*

To prevent avoidance of the windfall profits tax by a transfer of a portion of a property, the bill provides that oil produced from a portion of a property which was transferred after 1978 is not to constitute either stripper or newly discovered oil if the oil would not have qualified as stripper or newly discovered oil had the property not been subdivided. This provision is intended to prevent abuses resulting from transfers of portions of properties designed to create new properties qualifying for special treatment. In addition, in the case of post-1978 transfers of any portion of a property, the bill requires allocation of the BPCL among the portions of the divided property.

c. *Determination of selling or removal price*

The term 'removal price' generally means the amount for which the barrel of oil is sold. The bill provides special rules for determining a constructive sale price when oil is removed from the premises prior to sale, when the sale is between related parties, or when refining is begun prior to the oil's removal.

d. *Treatment of State severance taxes*

Various States impose severance or production taxes on the extraction of oil. These taxes are imposed either on each unit of production as a fixed fee per barrel or as a percentage of the value of each barrel.

Severance taxes generally are imposed on the owners of the various interests in a property (i.e., the operator, other investors, royalty owners, etc.). However, the taxes normally are paid by the first purchaser of the oil, who withholds the tax from the amount paid to the producer and royalty owners. For Federal income tax purposes, the amount of severance taxes is included in the producer's or royalty owner's gross income from the property, and an offsetting deduction for the severance tax is permitted.

The bill permits a deduction in computing taxable windfall profits for the State severance taxes imposed on the windfall profit element of the price of a barrel of oil—the difference between the selling price and the adjusted base price. The severance tax adjustment is necessary to avoid placing an undue burden on the producer of oil when the combined effect of the 60 percent windfall profit tax rate, the severance tax, and State and Federal income taxes is taken into account. However, at a lower tax rate, such as the 50 percent rate imposed on the first $9 of windfall profit on the sale of a barrel of newly discovered oil or incremental tertiary oil and on Sadlerochit oil in Alaska, the reduction for severance taxes is not provided. To discourage States from raising severance taxes at the expense of the federal Treasury, the amount of the severance tax adjustment may not exceed the severance tax that would have been imposed on the windfall element at the rate of severance tax in effect on March 31, 1979.

e. *Regulatory authority*

The bill authorizes the Secretary of the Treasury to prescribe such regulations as may be necessary to effectuate the purpose of the tax. The windfall profit tax is based on several concepts used in previous price control regulations. To apply these concepts within the context of an excise tax structure, the Secretary may have to prescribe regulations which interpret how the price control regulations are to be applied for the windfall profit tax. The regulatory authority is essentially the same as the authority which the Secretary ordinarily has with respect to tax legislation. Although it is not anticipated that major changes in price control regulations will be needed to apply them for tax purposes, references to price control regulations in the bill are not to be interpreted as denying the Secretary the usual regulatory authority.

9. Taxable Income Limit

The windfall profit on a barrel of oil may not exceed the net income attributable to the barrel. In applying this limitation, the net income attributable to a barrel is determined for the taxable year by dividing the taxable income from the property which is attributable to taxable crude oil by the number of barrels of that oil produced from the property during the taxable year. In computing net income for this purpose, taxable income from the property is determined under section 613(a) of the Internal Revenue Code (relating to percentage depletion) but without any deductions for depletion, intangible drilling and development costs under section 263(c) (except the costs of drilling a dry hole), and the windfall profit tax. For this provision, "property" has the meaning given to it in code section 614, not in the price control regulations.

The bill further provides that, in determining the 100-percent limit, the producer's taxable income from the property is to be reduced by the deduction for cost depletion which would have been allowable if all intangible drilling costs (other than those incurred in drilling a nonproductive well) had been capitalized and taken into account in computing cost depletion, and if the producer had used cost depletion for the property for all periods (even if he had actually used percentage depletion on his income tax return). However, if a producer actually capitalizes intangible drilling costs for income tax purposes, he may reduce his taxable income from the property by whatever amounts he deducts under section 611 of the Code in connection with those costs (either as cost depletion or depreciation) instead of assuming that all of those costs were deducted as cost depletion.

The bill provides a special rule for determining the taxable income limit in the case of certain transfers of proven oil or gas properties after 1978. If a transfer of a proven property would result in an increase in the amount by which a transferee producer's taxable income could be decreased by virtue of a larger imputed depletion deduction, the bill provides that the transferee producer may compute his imputed cost depletion deduction on only those costs incurred during periods after the transfer of the property. For purposes of this rule, a proven property is given the same meaning as that applicable to the Code's limitation on the allowance for percentage depletion in the case of oil. This rule applies to any post-1978 transfer, including leases and subleases of an interest (including an interest in a partnership or a trust) in any proven oil or gas property.

In the absence of this rule, the owner of a producing property with a low cost basis could transfer the property to another who could hold the property at an increased basis. The increased basis would increase the cost depletion deduction and, therefore, lower the taxable income limitation. The net effect could be the avoidance of a significant portion of the windfall profit tax liability. For example, if an operator owned a producing property with a cost basis of $2 per barrel, lifting costs of $2 a barrel, an adjusted base price of $8 a barrel and a selling price of $18 a barrel, that operator would pay a windfall profit tax on $10 for each barrel produced ($18 minus $8). If the owner were to sell the oil in place at a cost of $10 per barrel for each barrel of estimated reserve, the transferee would have a cost depletion deduction of $10 a barrel and other costs of $2 a barrel; his taxable income limitation would be $6 ($18 minus $12). Thus, the windfall profit subject to tax would be reduced from $10 to $6 by the transfer. The transfer rule in the bill would provide a net income limit of $16, so that the taxable windfall profit would continue to be $10.

If any portion of the taxable crude oil removed from the property is applied in discharge of a production payment, the gross income from such portion must be included in the gross income from the property in computing the taxable income of the producer.

10. Taxable Person

a. *General rule*

The bill imposes the windfall profit tax on the first sale of taxable crude oil and requires payment of the tax by the producer of the oil. Generally, the tax is to be withheld by the first purchaser of the oil and deposited with the Treasury by him. The bill defines the producer as the owner of the economic interest in the oil, generally the person who will receive the increased income resulting from decontrol and OPEC price increases. Thus, each investor and royalty owner who owns an economic interest in the oil (including government units and organizations described in code section 501(c)(3)) is liable for tax on its share of the gross revenues.

b. *Public education exemption*

The bill provides that if an economic interest in crude oil is held by a State or political subdivision thereof, or by an educational institution which is an agency or instrumentality of any of the foregoing, and under the applicable State or local law all of the net income received pursuant to such interest is dedicated to public education or to a permanent fund the income from which is dedicated to public education, then the windfall profit tax would not be imposed with respect to crude oil properly allocable to such interest. For this purpose, the term 'net income' means gross income reduced by production costs and severance taxes of general application. A severance tax of general application is one imposed at a uniform rate on all owners of rights in oil production, both public and private. The exemption would not apply to the extent another party had an economic interest in the production.

c. *Production payments*

The only case in which the bill imposes the tax on a person other than the holder of the economic interest in the oil is that of a production payment which involves payment of oil to someone until such time as the total cumulative payment has added up to a fixed number of dollars (as opposed to a fixed number of barrels). In these cases, the windfall from higher prices really is received by the owner of the residual interest in the oil, not the holder of the production payment, because the payment can be worked off with fewer barrels of oil owing to the higher price. The bill shifts the tax burden to the holder of the residual interest in this case. If the owner of the residual interest fails to capture the windfall profit immediately because of the nature of the contracted agreement with the production payment owner, the Secretary could, under Code section 6161, grant an extension of the time for payment of the tax.

11. Administrative Provisions

In administering the tax, existing business and administrative practices are relied on as much as possible to minimize the reporting and processing burdens. However, some additional recordkeeping and reporting will be necessary. The bill authorizes the Secretary to prescribe such recordkeeping, return filing, and information exchange requirements as may be necessary to carry out the purposes of the tax. The bill also contains specific provisions requiring operators and purchasers to furnish other persons the information necessary to calculate their liabilities under the tax.

a. *Deposit and return requirements*

The bill requires that only a few hundred persons file returns and make deposits of tax. The purchaser of any taxable crude (usually a refiner) must deposit the tax bimonthly under regulations to be promulgated by the Secretary, must provide producers with monthly information statements with respect to their oil production, and must file quarterly returns with respect to the tax. The purchaser would deduct the tax from the amount he would otherwise pay to the producer. The purchaser's obligation to make the tax deposits are not affected by the fact that a producer may be entitled to tax relief under the net income limit. Except for the operator of the property, other parties (such as the operator's partners or royalty owners) normally would not be subject to any return filing, reporting or depository requirements.

Producers and purchasers occasionally enter into arrangements which allow the purchasers to pay for the oil sometime, e.g., 30, 60, or 90 days, after its delivery. Where such delayed payment contracts exist, the committee report on the House-passed bill states that the arrangement may constitute reasonable cause for the Internal Revenue Service to grant an extension of time, under Code section 6161, to pay the tax. Such an extension would not be granted to integrated companies and, as generally is the case under section 6161, interest (but not penalties) would accrue on the unpaid tax for the duration of the extension period.

The bill would require that the quarterly returns of the windfall profit tax be filed not later than the last day of the second month following the close of the quarter. This is the same as the requirement presently imposed with respect to other quarterly excise tax returns.

b. *Refunds of tax*

If the net income limitation provided in the bill reduces a producer's windfall profit tax liability, the producer or royaltyholder may claim a refund of the excess windfall profit tax paid at the time he files his annual income tax return.

12. Windfall Profit Tax Enforcement

a. *Imposition of tax at first sale*

DOE price controls must be applied at several stages of production and distribution, each of which presents an opportunity for noncompliance. In contrast, only one event determines the windfall profit tax liability—the first sale. Because the tax is imposed on the producer and collected at the first sale by the purchaser, there is only one opportunity for a party to falsify "well data," such as meter readings or oil classifications. The items of information required to calculate the tax liability have to be reported or certified under the provisions of the bill. Each of these items is an operative element in the determination of any party's tax liability, so that the misrepresentation of any item gives rise to the imposition of the appropriate tax sanction. Each item of information also must be categorized as a "material fact" necessary for the filing of a valid return or the furnishing of accurate information statements. As a result, supporting records must be maintained, and misrepresentation of any of these items will render a party subject to any applicable civil or criminal sanction.

b. *Information requirements and penalties*

The bill requires the purchaser to furnish monthly statements to the producer. These statements must show the following items: (1) the amount of oil purchased, (2) the purchase price, (3) the base price and adjusted base prices, (4) the amount of tax withheld, and (5) any other information that is required by regulations. In addition, the operator of the well would be required to furnish the purchaser with such certified information as may be specified by regulation. Such information must include the type and classification of the oil purchased.

Noncompliance with the obligations imposed by the windfall profit tax subjects the producer both to the generally applicable civil and criminal penalties and those set forth in the bill. Specifically, the bill makes it a misdemeanor punishable by a fine of up to $10,000 and up to 1 year of imprisonment to fail willfully to comply with these obligations. Further, additions to tax for failure to comply are required. In addition, the obligations imposed upon the various parties by the windfall profit tax also are subject to generally applicable tax penalties for civil or criminal fraud, as well as those for negligence.

c. *Burden of proof*

The inclusion of DOE regulation concepts in the windfall profit tax does not affect the general rule that the burden of establishing the entitlement to preferential tax treatment is upon the taxpayer asserting that right. Each producer must be prepared to establish the various items upon which windfall profit tax liability is predicated, including the classification and base price of oil sold and the category to which the producing property belongs.

d. *Responsibilities of DOE*

Responsibility for administration and enforcement of the windfall profit tax will fall primarily upon the Treasury and the Internal Revenue Service. However, under OMB guidelines on the Privacy Act, DOE is not prevented from assisting the Treasury and the Internal Revenue Service by granting access to records held by DOE. It is also anticipated that DOE will assist the Secretary in formulation of regulations under the tax. In addition, DOE certifications of qualified tertiary enhanced recovery projects and release of front-end money for such projects are recognized specifically for windfall profit tax purposes.

13. Interaction with Income Tax

a. *Deductibility*

Under the bill, a deduction from Federal income taxes for windfall profit taxes paid is permitted. Such a deduction is consistent with the usual treatment of excise taxes and prevents the imposition of combined income and excise taxes in excess of the taxpayer's gross windfall profit.

b. *Depletion*

Generally, percentage depletion is not available in the case of oil and gas production. However, independent producers and royalty owners, those not involved in the "downstream" activities of the oil business, are entitled to percentage depletion to the extent that their average daily production does not exceed a specified exemption. For 1979, the exemption is 1,200 barrels per day or the equivalent amount of natural gas. The exemption will be established permanently at 1,000 barrels per day in 1980. Oil production eligible for percentage depletion represents approximately 23 percent of domestic production, which is split about evenly between royalty owners and independent producers. The rate of percentage depletion is 22 percent of gross income from the property, but this is scheduled to phase down to 15 percent between 1980 and 1984 except for oil produced from secondary and tertiary recovery, which remains at 22 percent depletion until 1984 when it too drops to 15 percent. The percentage depletion deduction may not exceed 65 percent of the taxpayer's overall net taxable income, computed without regard to the depletion deduction, net operating loss carrybacks, or capital loss carrybacks. In addition, the percentage depletion deduction from any single property may not exceed 50 percent of the taxpayer's taxable income from the property, computed without regard to the depletion deduction.

The percentage depletion allowance is calculated by multiplying the taxpayer's gross income from the property by the applicable percentage specified in the Code. Thus, the amount of the taxpayer's gross income from the property directly affects the amount of the percentage depletion deduction. Absent the provision in the bill to the contrary, the increase in the sales price of oil occasioned by decontrol would result in a proportionate increase in the percentage depletion allowance.

The bill provides that, in determining the percentage depletion allowance under sections 613 and 613A of the Code, gross income is to be reduced by the difference between the selling price and the adjusted base price of taxable oil (i.e., the windfall profit without regard to the severance tax adjustment). Also, for determining the 50-percent and 65-percent-of-taxable-income limits on percentage depletion, the windfall profit tax itself is not to be deducted in determining taxable income.

14. Effective Date

The windfall profit tax applies to oil removed on or after January 1, 1980. While the tax is intended to be consistent with President Carter's oil price decontrol program, the tax will apply regardless of whether that program is in fact carried out or whether controls are reimposed at some time in the future.

B. Trust Fund

The bill creates a special trust fund, called the Energy Trust Fund, in the U.S. Treasury for the receipts of the windfall profit tax. The Energy Trust Fund is structured in a manner similar to existing trust funds administered by the Secretary of the Treasury.

The Secretary must determine the amounts to be transferred to the fund on a monthly basis. Such amounts are to be based on estimates of the revenue produced from the windfall profit tax. If estimates prove to be either excessive or insufficient, adjustments are to be made in subsequent transfers to the extent necessary to rectify any earlier error. The Secretary must manage the trust fund as the trustee, and must report to Congress on its financial condition at the close of each fiscal year ending on or after September 30, 1980. This report must include the results of the fund's fiscal year operations and a projection of its condition for the following 5 fiscal years. This report will be printed as a House Document. Any amounts not required for current withdrawals must be invested in interest-bearing obligations of the United States. The Trust Fund may purchase these obligations either at the issue price, if an original issue, or at the market price, if an outstanding obligation. Such obligations may be sold by the Fund at the market price. Any income from the fund's investments will be credited to it.

Amounts in the trust fund are to be available, as provided by future authorization and appropriation Acts, for expenditures for purposes to be specified by law. The amount and purpose of these expenditures will be determined by the Congress in subsequent legislation, which will be developed and reported by the appropriate legislative committees of both Houses.

C. Study of Decontrol and Tax

The bill requires the President to submit a report to the Congress no later than January 1, 1983, on the effect of decontrol and the windfall profit tax on (1) domestic oil production; (2) oil imports; (3) oil company profits; (4) inflation; (5) employment; (6) economic growth; (7) Federal revenues; and (8) national security. The report is to be accompanied by such further energy-related legislative recommendations as the President may care to make.

III. REVENUE EFFECTS

Table 1 shows the revenue effects of the windfall profit tax in calendar years 1980 to 1984. Table 2 shows revenue effects in fiscal years 1980 to 1984. The revenue raised is estimated to be $3.7 billion in calendar year 1980, $7.7 billion in 1981 and $9.7 billion in 1982. In fiscal year 1980 the revenue raised is estimated to be $2.6 billion.

The windfall profit tax by itself will raise a certain amount of revenue, shown in the table as the "gross windfall profit tax." However, imposition of the windfall profit tax will cause several changes in individual and corporate income tax receipts. The "net windfall profit tax" in tables 1 and 2 is the gross windfall profit tax minus the reduction in income tax receipts resulting from the windfall profit tax.

There are essentially four reasons why imposition of a windfall profit tax can be expected to change individual income tax receipts. First, the bill denies percentage depletion on the amount of gross income defined to be a windfall profit. This change increases income tax paid by independent oil producers and royalty owners and is shown separately in tables 1 and 2. Second, the windfall profit would itself be a deductible expense under the income tax. Third, the windfall profit tax generally would be deductible under State income taxes, thereby reducing taxpayers' Federal income tax deductions for State income taxes. Finally, the imposition of the windfall profit tax can be expected to cause a reduction in oil drilling and production, which would affect the income tax paid by oil producers. The revenue estimates in tables 1 and 2 attempt to measure the effect of all of these factors on income tax receipts in deriving the net revenue raised by the windfall profit tax.

Under the bill, the gross windfall profit tax is put into an energy trust fund. Thus, trust fund receipts, excluding interest, are expected to be $6.1 billion in calendar year 1980, $12.9 billion in 1981 and $16.5 billion in 1982. The trust fund receipts are expected to be $3.6 billion in fiscal year 1980.

The revenue estimates are highly sensitive to the assumed world oil price. The assumption used is an $22 price for unregulated domestic oil in the third quarter of 1979, growing at the rate of inflation plus one percent per year. The $22 price is approximately the wellhead price for uncontrolled domestic crude oil which will result from the recent price increases announced by OPEC.

Table 1.—Calendar year revenue effect of House-passed windfall profit tax

[In millions of dollars]

	1980	1981	1982	1983	1984
Gross windfall profit tax	6, 118	12, 901	16, 459	16, 672	16, 884
Reduction in income taxes	−2, 592	−5, 578	−7, 211	−7, 489	−7, 669
Tax increase from disallowing depletion on windfall profit	180	380	445	400	379
Net windfall profit tax	**3, 707**	**7, 703**	**9, 694**	**9, 643**	**9, 594**

Table 2.—Fiscal year revenue effect of House-passed windfall profit tax

[In millions of dollars]

	1980	1981	1982	1983	1984
Gross windfall profit tax	3, 580	10, 497	16, 233	16, 615	16, 691
Reduction in income taxes	−1, 100	−3, 913	−6, 301	−7, 308	−7, 535
Tax increase from disallowing depletion on windfall profit	80	269	409	425	390
Net windfall profit tax	**2, 560**	**6, 852**	**10, 341**	**9, 733**	**9, 546**

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