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## The Sharp Commission proposal: How will it affect oil producers?

Mella McEwen  
Oil Editor  
Midland Reporter-Telegram

By Bob Landreth

Independent oil and gas operators have probably been wondering how they will fare under a new business tax designed to lower property taxes, in line with the Texas Supreme Court's ruling that the current property tax system is unconstitutional. An analysis is outlined below.

The Tax Reform Commission, appointed by the Governor and headed by John Sharp, has been wrestling with this issue for well over a year, holding hearings in many cities across the state and weighing a myriad of proposals. The sense is that the Commission's recommendation will carry a lot of weight during the upcoming special session of the Legislature, scheduled to begin around April 17. At the risk of offending some of the more conservative local independent producers, it is my feeling that the Sharp Commission's proposal, if left intact, is probably as favorable as we could hope for.

The Commission acknowledged, at its Midland hearing, that the oil and gas industry is already the most heavily taxed business in the State. Several of us expressed the opinion that our industry should be exempt from any new tax because of the severance taxes which we, and no one else, already pay. Unfortunately, because of current industry economic conditions, that argument has no traction -- especially since we are going to realize significant savings on property taxes, as discussed below.

The Sharp Commission's task was relatively straightforward: Devise a plan that will generate sufficient revenue to result in a significant reduction in property taxes well below the current tax rate cap of \$1.50 for Maintenance and Operating (M&O) budgets of school districts. Ninety percent of the school districts in the state are at or close to the cap. Contrary to public perception, the Commission was not charged with raising additional tax revenue for education, or determining what the level of educational spending should be.

The Commission decided that the \$1.50 cap should be reduced by 50 cents, or 33 percent. This required coming up with a new tax plan sufficient to generate approximately \$6 billion annually. The Commission, as I understand it, is relying on data provided by the State Comptroller as to how much the new business tax is likely to generate, which by itself is supposed to be approximately \$4.2 billion. The Commission will also propose a new tax on cigarettes estimated to raise \$800 million annually, plus using \$1 billion of the state's current \$4.3 billion surplus, in order to generate the \$6 billion needed. There is speculation that this surplus may be considerably larger than currently estimated.

The heart of the Sharp Commission's proposal is a broad-based tax on all businesses within the state with the exception of sole proprietorships, the justification being that any business entity receiving liability protection from the State by virtue of its business structure should bear the tax. The tax will be 1 percent of gross revenues, after deductions for either payroll or "cost of goods sold" (the difference being the "margin.") Wholesalers and retailers will pay one-half of one percent. A business' federal tax return will be used as the starting point, from which specific revenues and allowable deductions will be retrieved. The "margin" will be apportioned to Texas-based revenue sources in the same manner as franchise taxes are currently apportioned.

I have been told by members of the Sharp Commission that the royalty income of oil and gas operators will also be included in the tax. Permitted deductions for oil and gas operators will be those costs incurred at the lease level, which will include normal lease operating expenses, contract wages, severance taxes, ad valorem taxes, depreciation and depletion, and possibly IDC. An oil company could also choose to deduct payroll in lieu of the above, but for the vast majority of oil and gas companies, this would likely be a lesser deduction. Keep in mind that this is only a proposal, and may be modified significantly in its journey through the special legislative session.

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So, how will this new tax affect the typical oil and gas operator? Let's assume your gross income is \$1 million per year (a good round number) and your permitted deductions total 50 percent of your gross income, giving you a profit "margin" of \$500,000. You will pay \$5,000 under this new tax plan.

How much do you stand to save in ad valorem taxes? I pay a total combined tax rate of approximately \$2.30 per \$100 of valuation in the counties in which I operate. If the school district in each of those counties is currently charging the maximum M&O rate of \$1.50, I will save \$0.50/\$2.30, or approximately 22 percent of my total ad valorem tax bill. I have found over the years that ad valorem taxes on working interest properties typically run 4 - 4.5 percent of my gross revenue, about equal to the severance tax on oil. So, the "typical" company with \$1 million in gross revenue is currently paying about \$42,000 annually in advalorem taxes and will save 22 percent of that, or \$9,200. It appears that our industry is not going to realize the hoped-for significant net reduction in overall tax burden (which would be justified because of the severance and other taxes that we pay), but we may come close to breaking even or better, at least initially.

The real issue is what level these taxes will rise to in the future. There is no freeze on the property tax at the new anticipated rate of \$1 per \$100 valuation (any such cap would again be unconstitutional). Also, there is nothing to keep the Legislature from raising the 1 percent tax to 1 1/4 percent, for example, in the next biennium.

Which leaves one final, critical part of this discussion remaining: How are we going to get state spending under control in order to minimize future tax increases? The state budget increased by 112 percent from 1990 to 2000 under both Republican and Democrat administrations. The only way to reasonably bring spending under control is to pass a constitutional amendment, similar to the Tabor Amendment in Colorado and others now in place in approximately 20 other states, limiting the growth in government spending to inflation plus population increase. Organizations such as the Texas Public Policy Foundation, of which Midlander Tim Dunn is currently vice chairman, are supporting this approach, together with using a greater percentage of future state surpluses to buy down additional property taxes, rather than let the politicians simply spend the money. These ideas are worthy of our collective effort and determination to achieve and should be pursued without delay.

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