Department of Revenue
Tax Division
Production Tax Audits

Presentation to
Legislative Budget and Audit Committee
April 6, 2013

Oil and Gas Production Tax Processes

Monthly Processes

- Oil and Gas Producers are required to make monthly installment payments of estimated taxes and surcharges to the Department.
- Oil and Gas Explorers and Producers are required to submit monthly information reports to the Department in accordance with AS 43.55.030 and 15 AAC 55.520.
- The Tax Division's Economic Research Group analyzes the monthly information reports submitted by taxpayers on a regular basis.
- Tax Technicians in the Oil and Gas Production Audit Group review and document all information that is submitted by taxpayers each month. They also assist our Accounting Group to ensure that oil and gas revenues are properly accounted for and recorded as payments come in.

Oil and Gas Production Tax Processes (continued)

Annual Processes

- On March 31 of each year, oil and gas tax filings (returns) and other information are required to be received by the Department. If March 31 falls on a weekend or holiday, the filing is due on the next business day.
- The March 31 filing is a true-up of the twelve estimated monthly payments that were received by the Department in the previous year.
- Tax filings undergo desk reviews by Oil and Gas production tax auditors when they are received. Full audits are conducted at a later date.
- Requests for refunds of overpayment of estimated tax, do not accrue interest if they are refunded by the Department within ninety days.

Production Tax Audits/Assessments

- Production Tax Audits are not Performance Audits.
- Production Tax Audits are not utilized to determine if any given statutory provision is "working."
- The purpose of an oil and gas production tax audit/assessment is to ensure that the taxpayer has filed and paid the appropriate amount of production tax as required by Alaska statutes and regulations.
- Pursuant to AS 43.55.075, the amount of a tax imposed by this chapter must be assessed by the Department within six years after the return was filed.
- Taxpayers are also required to file amended returns if a decision of a regulatory body or court affects a previous return.
- Taxpayers have the right to appeal the results of audit assessments.
- Generally speaking, our oil and gas production tax audit assessments have ranged from $(5)-$82.5 million annually over the last five years. For comparison purposes, in the year that we assessed $82.5 million (FY-11), we collected over $4.5 billion in production tax revenues. The assessments for FY-11 were less than two percent of the total production tax revenues.

Production Tax Audits/Assessments (continued)

- Due to the interest and penalty provisions, there is an incentive for taxpayers to be as accurate as possible on their estimated monthly payments and tax return filings.
- If an assessment is issued, it is usually because the taxpayer and the Tax Division's audit staff have a difference of opinion as to how the statutes apply to a certain set of facts.
- If an assessment is issued, it is then subject to the appeals process which starts within the Tax Division, and can be appealed all the way up to the Alaska Supreme Court.

Oil and Gas Production Tax Credit Processes

- The Tax Division receives applications for oil and gas production tax credits throughout the year.

- All tax credit applications undergo a due diligence review prior to granting of the credit. It is important to note that due diligence reviews are often as detailed as a full audit. The Department retains the right to perform a full audit at a later date.

- **All** alternative credits for oil and gas exploration (AS 43.55.025) undergo a full audit **prior to being issued**.

- Expenditures which support credits that have been applied against a tax liability are audited at the time of the tax return.

Confidentiality

- Pursuant to AS 40.25.100 and AS 43.05.230(a) the Tax Division is required to hold taxpayer information confidential.
- Due to the confidentiality restrictions above, the Department is unable to discuss any specific information contained in any given audit or assessment.
- The statutes do allow the Division to release certain information so long as it is aggregated amongst three or more taxpayers.
- The Tax Division does publish certain aggregated statistical information each year in both its Revenue Sources Book, and Annual Report.
- The Tax Division has indicated several times that it is allowed to share taxpayer specific information (i.e. audit information) with legislators in executive session, so long as they sign the necessary confidentiality agreements, etc. To date, no one has taken us up on this offer.

Audit Effectiveness

- The Tax Division conducts a full audit on each and every production tax return that is filed where the taxpayer has a tax liability.

- The Division also conducts full audits of all AS 43.55.025 (exploration) claims for credit **BEFORE** a credit certificate is issued.

- The timeliness of ACES audits is not an issue. We have six years to conduct an audit and, to date, we have never missed a statutory deadline. Although we only had three years under ELF to audit those filings, oftentimes it took longer than three years, and taxpayers agreed to extend the statute of limitations. This is one of the reasons why the legislature in 2007 extended the time limit to conduct audits under ACES.

- In regards to the "level of assessment," it is not a good thing to be consistently issuing large assessments against any group of taxpayers. A lower level of assessment signifies a better understanding of the tax system and/or better voluntary compliance by taxpayers.

Impediments of ACES/PPT Audits

- **Amount of Data under ELF:**
  - Gross Value at the Point of Production (GVPP) = Taxable Volume * Taxable Value
    - Taxable Value was defined as:
      - Destination (Sales) Value; less
        - Marine Tanker Costs;
        - TAPS and Other Alaska Pipeline Tariff(s) Costs; and
        - Quality Bank Adjustments
  - GVPP * ELF rate (<1) * Tax Rate (12.25% first 5 years, 15% after that) = Monthly Production Tax
  - Less Credits + Conservation Surcharges = Total Tax Due

Impediments of ACES/PPT Audits (continued)

- **Amount of Data under ACES:**

  - GVPP = Taxable Volume * Taxable Value

    - Taxable Value defined as:
      - Volume of Taxable Oil and Gas Produced * Wellhead Value

  - GVPP - 1/12th of Total Annual Lease Expenditures (CAPEX and OPEX) = Monthly Production Tax Value (PTV) (used to calculate monthly progressivity tax when PTV > $30 per barrel);
  - Monthly PTV * Base Tax rate = Base Tax;
  - Monthly Progressivity + Base Tax = Monthly Production Tax Due;
  - Monthly Production Tax Due - Credits = Annual Tax Due;
  - Plus Conservation Surcharge = Total Tax Due.

Impediments of ACES/PPT Audits (continued)

- **Amount of Data under ACES (cont.):**

- **Lease Expenditures:**
  - Audit staff obtain information on lease expenditures from numerous sources through the audit process.

- **Taxpayer's Accounting System**:
  - This group of records provides the first step to reconcile lease expenditures claimed on the tax return. Not all taxpayers have Joint interest Billings (JIB) and Joint Account Data Exchange (JADE) data, however, all taxpayers have accounting systems where they maintain the necessary information to file their tax returns.

- **Joint Interest Billings** (JIBs):
  - Taxpayers that are working interest owners in a unit receive monthly JIBs from the unit operator. The JIBs are detailed billings of all expenditures made during the month in a unit. The taxpayers submit the JIBs received from unit operators to the Tax Division each month. A monthly JIB can be up to 300 pages in length, depending on the size of the project.

Impediments of ACES/PPT Audits (continued)

- **Amount of Data under ACES (cont.):**

- **Exclusions and Adjustments to the JIBs:**
  - Certain expenditures are not allowed as lease expenditures under AS 43.55. Each taxpayer excludes expenditures from the JIBs and makes additional adjustments to billed expenditures, in accordance with that taxpayer's interpretation of AS 43.55. The taxpayer's claimed expenditures are reconciled to the taxpayer's books and records. Some taxpayers provide detailed information about the "exclusions" to our audit staff, but other taxpayers do not – they contend that they do not have to provide to the Department documentation of what was not claimed on the return. In those instances, reconciliation of claimed expenditures (from the JIBs to the taxpayer's accounting system to the tax return) becomes a time-consuming exercise.

Impediments of ACES/PPT Audits (continued)

- **Amount of Data under ACES (cont.):**

- **Joint Account Data Exchange (JADE):**
  - This data is captured and sent electronically by the unit operator to each working interest owner. This data contains references to source documents of the operator and is sometimes provided by the taxpayer in support of lease expenditures claimed. Annual JADE data for a taxpayer may contain millions of lines of data for one unit.

- **Authorization For Expenditure (AFE):**
  - These documents are also referred to as "Cost Center" projects. AFE's provide project descriptions which help the auditors determine where to focus audit resources. While not voluminous individually, there may be hundreds AFEs or Cost Center projects underway in a unit during an audit period.

Impediments of ACES/PPT Audits (continued)

- **Amount of Data under ACES (cont.):**

- **Invoices in support of Claimed Expenditures:**
  - Auditors examine invoice listings to identify lease expenditures that are not allowable under AS 43.55. The volume of claimed expenditures for large units is often in excess of one million transactions.

- **Data from other State Agencies:**
  - Plans of Development (POD) and Plans of Operation (POO). Auditors review POD's and POO's on file with the Department of Natural Resources (DNR) for taxpayer projects during an audit year. Actual POD and POO documents lead the auditor to other documents within the DNR, filed by the taxpayer that may contain elements of excluded costs.

Impediments of ACES/PPT Audits (continued)

- **Amount of Data under ACES (cont.):**
- **Data from other State Agencies (continued):**
  - Data from Department of Environmental Conservation (DEC). Information is obtained from DEC regarding spills and unplanned releases of hazardous substances. The information is used by auditors in cost and project analysis. It is manually incorporated into audit work papers.
  - Volume data reported to the Alaska Oil and Gas Conservation Commission (AOGCC). Although the audit of lease expenditures typically does not include reconciliation of taxable volumes, swings in unit production between months or within months will assist in identifying conditions that may cause expenditures excluded under AS 43.55.

Impediments of ACES/PPT Audits (continued)

- Complexity of Tax
- New Tax = No institutional knowledge to tap into.
- Constant changes to the tax laws. There have been changes made to the statutes and regulations each year since ACES was first implemented.
- **Additional Projects:** In support of the audit function, the audit group also performs numerous other duties:
  - Auditors conduct desk reviews of all annual tax return filings
  - Credit reports generated monthly for Economic Research Group, DNR, and other outside agencies
  - Due diligence reviews (frequently as detailed as a full audit) of credit applications
  - Process cash purchase requests for credits
  - Provide support for annual legislative audits
  - Updating processes for changes in the law and new systems
  - Work with DNR for exploration projects and information sharing
  - Write regulations
  - Develop and test new systems
  - Quarterly calculations of gas prevailing values (North Slope and Cook Inlet)
  - Annual calculations of ANS prevailing values

Audit Staff Qualifications and Experience

- The Tax Division has a total of 19 FTE's in our Production Tax Audit Group. Of those 19 employees, we have:
  - 3 supervisors;
  - 8 auditors that are dedicated to production tax audits;
  - 6 auditors that are dedicated to credits audits; and
  - 2 tax technicians
- Our auditors range from an Oil and Gas Revenue Auditor (OGRA) I – OGRA IV
  - Starting pay for and OGRA I is $54,828;
  - Starting pay for an OGRA IV is $82,104;
    - (salary schedules can be found at: http://doa.alaska.gov/dof/payroll/sal_sched/0711ggw_200.pdf)
- The average years of oil and gas production tax audit experience is 5.5 years for the production tax audit group, and 4.25 years for the credit group.

Audit Staff Qualifications and Experience (continued)

- **For an OGRA I position, minimum qualifications include:**

- A bachelor's degree from an accredited college in accounting, finance or any business area that includes at least 18 semester hours (24 quarter hours) in accounting, auditing, or tax. Three semester hours (four quarter hours) in business law or statistical sampling may apply toward the required credit hours.

  <u>Or</u>
- Possess a Certified Public Accountant certificate.

  <u>Or substitution:</u>
- A bachelor's degree from an accredited college in any area that includes at least 18 semester hours (24 quarter hours) in accounting, auditing, or tax. Three semester hours (4 quarter hours) in business law or statistical sampling may apply toward the required credit hours.

  <u>AND EITHER</u>
- One year of professional experience auditing or examining financial information and data as an Accountant I or Tax Auditor I with the State of Alaska or the equivalent with another employer.

  <u>OR</u>
- Two years of journey level technical experience performing technical tax, accounting or audit functions in the examination, verification, maintenance, reconciliation, and reporting of accounts and financial data as a Tax Technician III or Accounting Technician II with the State of Alaska or the equivalent with another employer.

Audit Staff Qualifications and Experience (continued)

- **For an OGRA IV position, minimum qualifications include:**

- A bachelor's degree from an accredited college in accounting, finance or any business area that includes at least 18 semester hours (24 quarter hours) in accounting, auditing, or tax. Three semester hours (four quarter hours) in business law or statistical sampling may apply toward the required credit hours.
  AND
- Two years of professional experience auditing and examining financial information and data specific to the oil and gas industry as an Oil and Gas Revenue Auditor III with the State of Alaska or the equivalent with another employer.
  Or substitution:
- A bachelor's degree in any area that includes or is supplemented by 18 semester hours (24 quarter hours) in accounting, auditing, or tax. Three semester hours (four quarter hours) in business law or statistical sampling may apply toward the required credit hours.
  AND
- Three years of professional experience auditing and examining financial information and data specific to the oil and gas industry as an Oil and Gas Revenue Auditor III with the State of Alaska or the equivalent with another employer.
- Possession of a Certified Public Accountant certificate may substitute for the education. There is no substitution for the required experience.

- Position descriptions can be found at: http://agency.governmentjobs.com/alaska/default.cfm?SearchLetter=O&action=agencyspecs

Audit Staff Qualifications and Experience (continued)

- For comparison purposes, following are the statistics for the production tax audit group prior to PPT:
  - Total of 9 FTE's
  - 1 supervisor;
  - 6 production tax auditors;
  - 0 credit auditors; and
  - 2 tax technicians
- Prior to PPT, our production tax auditors had an average of 18.5 years of oil and gas production tax audit experience.
- Due to attrition, retirement, and transfers to other Departments in 2006, the production tax audit group experienced nearly 100% turnover of production tax auditors.

Audit Methodology

- **Methodology for Production Tax Audits:**
- Production tax audit methodology under ACES is unique, however, it bears similarities to the audit methodologies that are utilized in other tax types.
- First, our auditors determine if producers and explorers have complied with monthly and annual reporting requirements for the given tax year;
- Second, they ensure that all necessary monthly installment payments have been made timely;
- Third, they verify that each taxpayer's tax liability has been properly calculated;
- Fourth, they confirm that sufficient documentation exists to support claims made on the tax return; and
- Finally, when appropriate, our production tax audit staff issue audit assessments well within the statute of limitations and in accordance with our statutes and regulations.

Status of Audits

- The Tax Division is currently in the process of finalizing the audits for oil and gas production tax returns covering the 2007 tax year, which were initially filed on March 31, 2008. There have been numerous amended returns filed for the 2007 tax year (due to FERC rulings, regulatory changes, etc.).
- Part of the complexity of auditing oil and gas production tax for the 2007 tax year is that half of the year is under PPT, and the other half is under ACES.
- The Tax Division anticipates having all of the 2007 audits finalized by late summer or early fall of 2013.
- Division staff have started on audits for the 2008-2009 tax years, for the taxpayers whose 2007 audits are complete.
- The Tax Division anticipates that, going forward, it will be able to cover two tax years in one audit, so for instance, we are starting to combine 2008-2009 tax years into one audit for certain taxpayers as our resources allow.

Summary

- ACES is a unique and complex tax type that consists of both taxes and credits. The Tax Division has split our auditors into two groups; one to audit the tax, and one to audit the credits.
- Large amounts of data must be reviewed manually:
  - The Division is in the process of implementing an integrated revenue management system which will help automate and streamline much of the review process, and will also allow us to expand our audits.
- Changes to the statutes and regulations:
  - The Division routinely conducts in-house training and workshops to keep our auditors and taxpayers up-to-date on all statutory and regulatory changes to the tax code.
- We provide as much industry-related training for our audit staff as our budget allows.
- Tax Division staff are active in both the Federation of Tax Administrators (FTA) and the Multi-State Tax Commission (MTC).
- The Division continues to refine our audit policies and procedures as audit issues are identified.

Questions?