Jonathan Bender

Partner
303.295.8456
Denver
jsbender@hollandhart.com

Colorado Court of Appeals Decides Important Severance Tax Case

Colorado Court of Appeals Decides Important Severance Tax Case

Insight — November 27, 2013

In November 2013, the Colorado Court of Appeals decided an issue that will impact all oil and gas producing companies doing business in state that planned to deduct return on investment (ROI) from gross lease revenues. In *BP America Production Company v. Colorado Department of Revenue*, the Court ruled that ROI is not a deductible cost for severance tax purposes.

In Colorado, companies that extract nonrenewable natural resources are required to pay a severance tax on the gross income derived from the sale of those resources. Colorado's severance tax statute defines gross income as the net amount realized by the taxpayer for the sale of the oil or gas. The net amount realized is calculated on the basis of gross lease revenues minus deductions for "any transportation, manufacturing, and processing costs borne by the taxpayer." This phrase was key to the taxpayer's argument and the court's decision in the *BP America Production Company* case.

BP sought a refund on its 2003 and 2004 returns by claiming deductions for the cost of operating transportation and processing facilities, for depreciation of its investment in the facilities, and for ROI associated with those facilities. The Colorado Department of Revenue allowed the claimed deductions for operating costs and depreciation attributable to the transportation and processing facilities, but did not permit a deduction for ROI. Specifically, the hearing officer concluded that ROI is not a transportation and processing cost, but is instead an "opportunity cost that reflects the cost of alternatives that were forfeited to pursue a certain action."

BP successfully appealed to the district court. In ruling for BP, the district court concluded that the use of the word "any" in the statute established that ROI is an allowable deduction. The Department appealed that ruling to the Court of Appeals, which ruled in favor of the Department.

On appeal, the Court of Appeals considered the plain meaning of the statute and the legislature's intent behind the phrase "any transportation, manufacturing, and processing costs borne by the taxpayer." In rejecting BP's argument that "any . . . costs" allows for such a deduction, the court (like the hearing officer) noted that ROI is the opportunity cost of capital, and opportunity cost is not a cost that has been expended or paid. Instead, an opportunity cost is a calculation of loss based on investment in one opportunity instead of another, more profitable opportunity.

Characterizing an opportunity cost as a "hypothetical cost," the Court of Appeals concluded that an opportunity cost is not one that has been expended to transport or process oil or gas from its point of extraction at the wellhead. It is only those costs that the legislature intended to qualify for deduction.

The Court of Appeals also based its conclusion in favor of the Department on the text of the statute itself. The terms "transportation, manufacturing, and processing" are specific terms that precede the more general term "costs." Based on the language of the statute, the Court of Appeals concluded that only costs incurred directly for the transportation or processing of oil or gas are allowable deductions under the statute.

In short, under the current ruling (which may be appealed to the Colorado Supreme Court), oil and gas producers are permitted to deduct costs incurred directly for operating a facility that is used for the transportation and processing of oil and gas under Colorado's severance tax statute. Indirect costs, however, such as ROI, are not within the intended deductions of the statute.
