SO, YOU THINK THAT SEVERANCE TAXES CAN BE DEDUCTED FROM GAS ROYALTIES UNDER KENTUCKY LAW? GUESS AGAIN.[1]

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In Kentucky, the vast majority of oil and gas leases provide for a one-eighth (1/8) royalty to the landowner or royalty owner. Most natural gas producers deduct a proportionate share of the severance taxes due and payable with respect to the natural gas severed from the earth from the one-eighth royalty due the royalty owner. Where a royalty owner under an oil and gas lease expressly agrees that the producer may deduct a proportionate share (i.e., one-eighth) of the severance taxes from the royalty otherwise due the royalty owner, the deduction might be appropriate. However, where an oil and gas lease contains no provision saddling the lessor with the obligation to pay any portion of severance taxes on severed/produced gas, it is improper and a breach of an oil and gas lease for the producer to deduct any portion of the severance taxes from the royalties due the lessor.

The Kentucky severance statute

Liability for payment of the natural resources severance and processing tax is governed by KRS § 143A.020, which provides:

> (1) For the privilege of severing[2] or processing natural resources in this state, a tax is hereby levied at the rate of four and one-half

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[2] "Severing" or "severed" means "the physical removal of the natural resources from the earth or waters of this state by any means," but does not include "the removal of natural gas from underground

percent (4.5%) on natural gas[3] and four and one-half percent (4.5%) on all other natural resources, such rates to apply to the gross value of the natural resources severed and processed except that no tax shall be imposed on the processing of ball clay.

(2) The tax shall apply to all **taxpayers** severing and/or processing natural resources in this state, and shall be in addition to all other taxes imposed by law.

KRS §§ 143A.020(1)-(2) (emphasis added). Only "taxpayers" are liable for payment of severance taxes. The term "taxpayer" is defined in KRS § 143A.010, which provides:

(4) "Taxpayer" means and includes any individual, partnership, joint venture, association, corporation, receiver, trustee, guardian, executor, administrator, fiduciary, or representative of any kind engaged in the business of severing and/or processing natural resources in this state for sale or use. In instances where contracts, either oral or written, are entered into whereby persons, organizations or businesses are engaged in the business of severing and/or processing a natural resource but do not obtain title to or do not have an economic interest therein, the party who owns the natural resources or has an economic interest is the taxpayer.

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storage facilities into which the natural gas has been mechanically injected following its initial removal from the earth." KRS § 143A.010(3).

[3] "Natural gas" is a "natural resource" within the meaning of KRS § 143A.020(2). KRS § 143A.010(2).

KRS § 143A.010(4). Under KRS § 143A.010(8), a party who only receives an arm's length royalty under an oil and gas lease, "shall not be considered as having an economic interest" in the gas severed and produced at the party's premises.

A recent summary judgment decision holds that a lessor has no obligation to pay severance taxes on severed or produced natural gas

One of the issues in *Asher Land and Mineral, Ltd. v. Nami Resources Company, LLC*, Bell Circuit Court, Civil Action No. 06-CI-00566, was whether Asher Land and Mineral, Ltd. ("ALM"), the lessor under three oil and gas leases, was obligated to pay any portion of the severance taxes due and payable under KRS § 143A.020(1) with respect to the natural gas severed and produced at its premises. In *Asher* there was no dispute that ALM was to be paid an arm's length one-eighth royalty, and that its three oil and gas leases (which antedated Kentucky's severance tax statute by decades) with Nami Resources Company, LLC ("NRC") contained no provisions obligating ALM to pay any portion of the severance taxes on gas severed or produced at its premises. Both parties moved for summary judgment on ALM's breach of contract claim against NRC for improperly deducting a proportionate share (i.e., one-eighth) of the severance taxes against the royalties paid to ALM under the leases.

On October 25, 2011, the Bell Circuit Court, in a well-reasoned summary judgment decision (the "Decision"), granted ALM summary judgment on its severance tax claim against NRC. The *Asher* court rejected NRC's argument that severance taxes were a post-production cost, but rather were a cost of production because the tax attaches the instant the natural gas leaves the ground at the wellhead. Decision at 16. The court reasoned that ALM played no role in the natural gas extraction process. Under Kentucky law, which is consistent with the law elsewhere, only working interest owners, which include gas producers, are responsible for the payment of the costs to produce natural gas, which are the costs incurred to explore for and bring natural gas to the earth's surface.[4]

In an effort to convince the *Asher* court that ALM was obligated to pay a proportionate share of the severance taxes with regard to the natural gas severed and produced at the leased premises, NRC cited several cases from outside Kentucky construing severance tax statutes other than the Kentucky severance tax statute. These cases included: *Sartor v. United Gas Public Service Co.*, 173 So. 103, 108-109 (La. 1937) (applying Louisiana law and holding that lessors are obligated to pay a proportionate share of severance taxes under § 7 of Act No. 140 of 1922, which provides that: "Every person … actually engaged in severing oil, gas, or other natural resources from the soil or water, or actually operating oil or gas property, or other property from which natural resources are severed, *under contracts or agreements requiring payment direct to the owners of any royalty interest, excess royalty, or working interest, either in money or in kind, is hereby authorized, empowered and required to deduct from any amount due, or from anything due, the amount of the tax herein levied before making such payment.*")

[4] Under certain circumstances, a lessor may be liable for its proportionate share of post-production expenses to get the gas to the market, which oftentimes is many miles away from the point of production. These expenses include gathering, compression, dehydration, treatment and third-party transportation.

(emphasis in original); *Heritage Resources, Inc. v. Nationsbank*, 939 S.W.2d 118 (Tex. 1996) (although the Texas severance statute is neither quoted nor cited in this decision, said statute imposes a tax "at the rate of 7.5 percent of the market value of gas produced and saved in this state by the producer" (Tex. Code Ann. § 201.052) and defines the term "producer" to include "a person who owns an interest, including a royalty interest, in gas or its value, whether the gas is produced by the person owning the interest or by another on his behalf by lease, contract, or other arrangement" (Tex. Code Ann. § 201.001(5)); *Gulf Refining Co. v. Stone*, 21 So. 19, 20 (Miss. 1945) (interpreting § 1(i) of Chapter 134 of Mississippi's Law of 1944, which expressly provided that "any person owning any royalty or other interest in any oil or its value, whether produced by him, or by some other person on his behalf, either by lease contract or otherwise," and holding that royalty owners are liable for their proportionate share of severance taxes under such statute); *Brown v. Shell Oil Co.*, 339 N.W.2d 709, 710-11 (Mich. Ct. App. 1983) (construing Michigan's severance tax statute and noting that a royalty owner is a "producer" who is expressly liable for payment of severance taxes under Mich. Comp. Laws § 205.301); *Ashland Oil Co. v. Jaeger*, 650 P.2d 265, 267-68 (Wy. 1982) (holding that royalty owners are liable for severance taxes under Wyoming law by virtue of Wyo. Stat. Ann. § 39-6-304(h), which provides that: "Any taxpayer paying taxes imposed by this article on any valuable deposit may deduct the taxes paid from any amounts due or to become due to the interest owners of such valuable deposit in proportion to the interest ownership."). Unlike the severance tax statutes at issue in these cases, the Kentucky severance tax statute is inapplicable to a lessor who merely receives payment of an arm's length royalty.

Implications of the Decision in Asher

There could be hundreds, if not thousands, of lessors with severance tax claims against lessees under oil and gas leases governed by Kentucky law. Under *Asher*, it is improper for an oil and gas lessee to deduct any portion of the severance taxes due and payable under KRS § 143A.020(1) where the lease contains no provisions permitting the lessee to deduct any portion of such taxes from the royalties due the lessor. In the aggregate, there could be millions of dollars of unadjudicated severance tax claims against gas lessees. Such claims might well be appropriately litigated in a class action suit.

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