COMMONWEALTH of VIRGINIA

Office of the Attorney General

Kenneth T. Cuccinelli, II
Attorney General

900 East Main Street
Richmond, Virginia 23219
804-786-2071
FAX 804-786-1991
Virginia Relay Services
800-828-1120
7-1-1

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The Honorable Emma N. Hagy
Commissioner of the Revenue for Tazewell County
101 East Main Street
Tazewell, Virginia 24651

Dear Ms. Hagy:

I am responding to your request for an official advisory opinion in accordance with § 2.2-505 of the *Code of Virginia*.

Issues Presented

You ask whether § 58.1-3712, which authorizes localities to impose a license tax on gas producers,[1] permits a taxpayer to deduct expenses and production costs from the gross receipts upon which the tax is imposed, when the receipts are for gas produced by means not in connection with coal mining. You also inquire regarding the scope of the Commissioner's ability to conduct audits relating to the collection of severance taxes authorized under § 58.1-3712.

Response

It is my opinion that § 15.2-3712 allows persons engaged in the production and operation of severing gas from the earth not in connection with coal mining to take certain deductions when the sale occurs at a point outside the county or city where the gas was extracted and the producer has incurred additional expenses for the gas to reach its destination. Those deductions might include, but are not limited to, depreciation, compression, maintenance, transportation fees, and personal property taxes; however, persons who are engaged in the production and operation of severing gas from the earth in connection with coal mining may not take such deductions. It further is my opinion that Commissioners of the revenue are authorized to perform audits in connection with their duty to assess license taxes.

Applicable Law and Discussion

Section 58.1-3712 provides in relevant part that

> [t]he governing body of any county or city may levy a license tax on every person engaging in the business of severing coal or gases from the earth. Such tax shall be at a rate not to exceed one percent of the gross receipts from the sale of coal or gases severed within such county. Such gross receipts shall be the fair market value measured at the

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[1] The license tax contemplated in § 58.1-3712(A) is for coal or gases. Your question concerns gases only.

> time such coal or gases are utilized or sold for utilization in such county or city or at the time they are placed in transit for shipment therefrom . . . . In calculating the fair market value, no person engaging in the production and operation of severing gases from the earth in connection with coal mining shall be allowed to take deductions, including but not limited to, depreciation, compression, marketing fees, overhead, maintenance, transportation fees, and personal property taxes.

One difficulty in analyzing this statute is that while it calls for a tax upon "gross receipts," the statute further provides that "gross receipts shall be the fair market value measured at the time such coal or gases are utilized or sold for utilization in such county or city or at the time they are placed in transit for shipment therefrom." The statute calls for the gross receipts to be valued "at the time" the gases are used or sold locally, or placed in transit.

This Office has opined that under this section, gross receipts may be measured at "two distinct times." These are either

> (1) when the coal [or gas] is used or sold for use within the taxing locality; or (2) when the coal [or gas] is placed in transit for shipment from the taxing locality. The use of the disjunctive indicates that two separate alternatives were intended . . . . Section 58.1-3712 thus contemplates that coal [or gas] will be either used or sold for use in the taxing locality or exported for sale in another jurisdiction. In the latter event, the fair market value for purposes of determining gross receipts is measured at the time the coal [or gas] is placed in shipment . . . . and should not include value added by the processing of the coal [or gas] in [another jurisdiction].[2]

Relying on this opinion, the Tax Commissioner has opined that although the term "gross receipts" generally does not contemplate deductions, that is not the case with respect to § 58.1-3712.[3] According to the Tax Commissioner, when the gases "severed by the taxpayer are [not] used or sold for use within the County, they must be valued when they are placed in transit for shipment."[4] Examining gases that were placed in transit for shipment at the wellhead, the Tax Commissioner concluded that the gases should be valued at the wellhead.[5] Clearly, no deductions may be taken for expenses incurred up to that point. As such,

> Gross receipts from sale may be used as a starting point when determining the value of the gases at the time they are placed in transit for shipment. Expenditures, however, which represent value added to the gases at, and subsequent to, the time they are placed in transit for shipment must be deducted. Such expenses may include processing, transportation and marketing expenses.[6]

Accordingly, if a sale takes place outside the County, the "gross receipts" received by the gas producer will be attributable in part to certain costs sustained after the point in time designated by the

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[2] 1990 Op. Va. Att'y Gen. 223, 224.

[3] Ruling of the Tax Comm'r, No. 99-306 (November 29, 1999). *See* VA. CODE ANN. § 58.1-3700.1 (Supp. 2011) (providing definition of "gross receipts"). I note that "the Commissioner's construction of a tax statute, while not binding upon [a] Court, is entitled to great weight." *See, e.g.,* Dep't of Taxation v. Wellmore Coal Corp., 228 Va. 149, 154, 320 S.E.2d 509, 511 (1984).

[4] *Id.*

[5] *Id.*

[6] *Id.*

statute for valuation. To illustrate, suppose that gas originating in Virginia is sold in Tennessee. If the gas extractor incurs additional expenses after the gases are placed in transit, those expenses can be deducted.[7]

In 2002, after the opinions of this Office and of the Tax Commissioner had been issued, the General Assembly, in an act "declaratory of existing law[,]" added to § 58.1-3712 language providing that "no person engaging in the production and operation of severing gases from the earth *in connection with coal mining* shall be allowed to take deductions, including but not limited to, depreciation, compression, marketing fees, overhead, maintenance, transportation fees, and personal property taxes."[8] This enactment suggests that the General Assembly accepted the opinions from the Tax Commissioner and the Attorney General,[9] but further provided that permissible deductions would be limited to those persons who are engaged in the production and operation of severing gases from the earth and who are doing so in a manner not in connection with coal mining.

In sum, persons who are engaged in the production and operation of severing gases from the earth and who do so not in connection with coal mining may take deductions, where appropriate, for among other things, "depreciation, compression, marketing fees, overhead, maintenance, transportation fees, and personal property taxes." Such deductions, however, are available only for expenses incurred *after* the gas was used or sold for use within the taxing locality or *after* it is placed in transit for shipment from the taxing locality. The point is to determine what the fair market value of the gas was before it was shipped outside of the locality.[10]

Turning to your inquiry regarding the ability of the Commissioner to conduct audits relating to the collection of severance taxes authorized under § 58.1-3712, I note that, while subsection (C) provides that "[a]ny county or city enacting a license tax under this section may require producers of coal or gas and common carriers to maintain records and file reports showing the quantities of and receipts from coal or gases which they have produced or transported[,]" it does not directly address audits. Neither its plain text nor any implication limits the ability of a Commissioner to perform an audit. Rather, this subsection makes express that a when a locality chooses to levy the license tax on the extraction of coal or gas, the locality may also require companies to maintain records regarding quantities and receipts relating to the production or transportation of the gas or coal.

Nevertheless, the Commissioner, who is charged with assessing license taxes,[11] is free to audit taxpayers who pay the license tax and to seek any necessary documentation in connection with

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[7] As a general proposition, I further note that a locality is entitled to impose license taxes only on those receipts based on business activity conducted within its jurisdiction. *See* § 58.1-3708(B) (2009). *See also* §§58.1-3732(A); 58.1-3732(B)(2) (2009).

[8] 2002 Va. Acts ch. 433 (emphasis added).

[9] *See* 2010 Op. Va. Att'y Gen. 7, 10 n. 13 and citations therein.

[10] I agree that the plain language of the statute contemplates that gross receipts tax is to be based on the fair market value of the gas, and not necessarily whatever amount the company received for the gas. I assume that, ordinarily, the price the company received for the gas is, in fact, its fair market value. Should a gas producer sell below market to a subsidiary in an effort to reduce its tax bill, the price would not represent the fair market value of the gas. Likewise, the price paid by an out-of-state buyer who must pay for the value added by subsequent transportation or processing costs, for example, would not reflect the fair market value of the gas at the time required by the statute.

[11] Sections 58.1-3101 (2009); 58.1-3109(1), (2) (2009).

deductions.[12] Indeed, the Commissioner is directed to require taxpayers "to furnish access to books of account or other papers and records for the purpose of verifying the tax returns of such taxpayers and procuring the information necessary to make complete assessment of any taxpayer's . . . license taxes[.]"[13]

Conclusion

Accordingly, it is my opinion that that § 15.2-3712 allows persons engaged in the production and operation of severing gas from the earth not in connection with coal mining to take certain deductions when the sale occurs at a point outside the county or city where the gas was extracted and the producer has incurred additional expenses for the gas to reach its destination. Those deductions might include, but are not limited to, depreciation, compression, maintenance, transportation fees, and personal property taxes; however, persons who are engaged in the production and operation of severing gas from the earth in connection with coal mining may not take such deductions. It further is my opinion that Commissioners of the revenue are authorized to perform audits in connection with their duty to assess license taxes.

With kindest regards, I am

Very truly yours,

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[12] For example, in Clinchfield Coal Co. v. Robbins, 261 Va. 12, 541 S.E.2d 298 (2001), the Supreme Court of Virginia concluded that a Commissioner of the Revenue lacked the authority to hire an accounting firm as an outside contractor to audit coal severance taxes, but all parties and the Court took as a given that the Commissioner himself could perform the audit of taxes assessed under § 58.1-3712(A).

[13] Section 58.1-3109(6).