Unintended Consequences of Recent Coal Severance Tax Legislation

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On March 27 Gov. Jim Justice (R) signed two bills that affect the coal severance tax in West Virginia: H.B. 3142,[1] which has the primary purpose of reducing the rate of severance tax imposed on steam coal; and H.B. 3144,[2] which creates a new severance tax rebate program for coal producers. Both bills became effective June 7.

This article discusses the coal severance tax bills, and highlights an unintended consequence resulting from the measurement of coal production for purposes of the severance tax rebate program.

Severance Tax Reduction for Steam Coal

H.B. 3142 provides for a three-year phasedown of the severance tax imposed on steam or thermal coal from 5 percent to 3 percent. On July 1 the severance tax rate for steam or thermal coal fell from 5 percent to 4.3 percent; on July 1, 2020, the rate will be reduced to 3.7 percent; and on July 1, 2021, the rate will be reduced to 3 percent.[3] Thermal or steam coal is defined as coal sold for the purpose of generating electricity.[4] The tax department introduced an interpretive rule on July 22 to provide additional guidance on the rate reduction, with a focus on the method of accounting for thermal or steam coal.[5] The coal sales contract must demonstrate that the coal is sold to an electric power company for the purpose of generating or producing electricity.

The bill eliminates the severance tax imposed for the privilege of extracting limestone and sandstone, effective July 1,[6] and establishes minimum amounts of distribution of the portion of coal severance taxes dedicated for the use and benefit of coal-producing counties, with the amount to be distributed to be equal to or over the amount distributed for the fiscal year beginning July 1, 2018.[7]

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Rebate of Severance Taxes Attributable to New Capital Investment

H.B. 3144 creates a new article in the West Virginia tax code for the establishment of a coal severance tax rebate program. The rebate program applies to "capital investment in new machinery and equipment or improvements to real property" when purchases or certain leases of tangible personal property or improvements to real property occur "on or after the effective date of this article."[8] Further, the "rebate… is allowed for capital investment in new machinery, equipment, or improvements to real property placed in service or use in [West Virginia] on or after the effective date of [Article 13EE]."[9] Machinery, equipment, or improvements to real property are deemed to be purchased before a specified date only if they were owned by the taxpayer, acquired by the taxpayer, or – in the case of leased machinery and equipment – if there was a binding writing lease in effect before the effective date of the new article.[10] Thus, the rebate program is available only for capital investment that is made on or after June 7.

Importantly, this is a rebate program wherein taxpayers claim the rebate at the end of the calendar year, in conjunction with filing an annual coal severance tax return, not a credit program under which taxpayers can take credits against the severance tax when monthly severance tax estimated returns are filed. The rebate offsets the portion of West Virginia severance taxes that is attributable to the increase in coal production resulting from the taxpayer's capital investment in new machinery, equipment, or improvements to real property[11] used at a coal mine or coal preparation and processing facility.[12] The maximum amount of rebate is determined by multiplying the amount of the taxpayer's rebate-qualifying capital investment in new machinery, equipment, or improvements to real property directly used in the production of coal at a coal mining operation in the state by 35 percent.[13] The amount of rebate that can be claimed on the return is determined by applying the calculated maximum rebate amount (35 percent of the capital investment) against 80 percent of the state portion[14] of the severance tax that is directly attributable to the increased coal production resulting from the taxpayer's qualifying taxpayer's capital investment.[15]

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The amount of severance tax attributable to the increase in coal production at a mine because of the capital investment is determined by comparing the base severance tax to the amount of severance tax for the calendar year of the rebate. When the amount of severance tax for a rebate year exceeds the base severance tax, the difference is the amount of state severance tax because of the increase in coal production at the mine that is attributable to the capital investment. Thus, while the rebate program is couched in terms of "production," the measurement for production is the amount of severance tax paid by the producer.

The base severance tax is the lesser of:

- the state portion of the severance tax on coal produced from the mine during calendar year 2018; or
- if the taxpayer has produced coal for five years at the mine at which its capital investment is placed in service or use, the average of the state portion of the severance tax on coal produced from the mine during the five-year period ending on December 31, 2018.

The base and current-year severance taxes, for these purposes, are calculated before allowance of any tax credits.[16] When the coal producer operates more than one mine in the state, or is a member of a controlled or affiliated group that operates one or more mines in the state, no rebate is allowed unless the total coal production from all in-state mines operated by the taxpayer or by members of the affiliated or controlled group has increased.[17] This provision prevents taxpayers from shifting production to one mine to take advantage of the rebate. Additionally, in no case shall the severance tax attributable to any mine other than the specific mine at which the capital investment is directly used in coal mining activities be offset by the rebate.[18]

When the eligible taxpayer is a new business that has produced coal in this state for two years before making the qualifying capital investment, the base is the average amount of state severance tax on coal produced in this state during the two-year period.[19] In other words, to be an eligible taxpayer, a coal producer or operator must pay coal severance taxes for at least two years before the

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capital investment is placed in service.[20] A producer may be an eligible taxpayer if it has experienced a change in business composition through merger, acquisition, split-up, spinoff, or other ownership changes or changes in the form of the business organization if the entity currently operating in West Virginia was operating in a different form of business organization in the state at least two years before the capital investment is placed in service or use.

In the case of business composition change through merger, acquisition, split-up, spinoff or other ownership changes, the current business may be an eligible taxpayer if at least 50 percent of the entity's business assets were actively and directly used in coal production activity in West Virginia for a two-year period.[21] If less than 50 percent of the assets were used in coal production in West Virginia, the new entity is not an eligible taxpayer until it has operated in the state for two years.[22] For a producer that began producing coal, and paying the coal severance tax, in October 2017, capital investment made during the last two months of 2019 can qualify for the rebate.

The rebate program prevents double dipping by taking both a West Virginia tax credit for the capital investment, while also claiming a rebate against severance tax for the same capital investment.[23]

As noted above, the rebate is claimed after severance taxes due for the calendar year are paid (via monthly estimates and an end-of-year "true up" return), with the allowable rebate being up to 80 percent of the state portion of severance taxes attributable to the capital investment. When the amount of rebate claimed exceeds 80 percent, the unused portion may be carried forward for a period not to exceed 10 years from the date the capital investment is placed in service or use in West Virginia.[24] Before claiming the rebate, the taxpayer must make a written application to the tax commissioner for allowance of the rebate, and the application must be filed no later than the last day for filing the taxpayer's annual severance tax return, including any extensions of time to file the return, for the taxable year in which the capital investment to which the rebate relates is placed in service or use. A separate application is required for each taxable year during which the taxpayer places new

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machinery, equipment, or improvements in service or use in a mine or coal preparation and processing facility in West Virginia.[25] Failure to file the rebate application results in the forfeiture of 25 percent of the rebate amount otherwise allowable.[26]

The rebate may be transferred to a successor entity, whether the successor results from a change in the form of the business or from a transfer or sale to a successor business that continues to operate the capital investment at the mine or preparation or processing facility.[27] However, no rebate earned by one member of a combined group, but not fully used by or allowed to that member, may be claimed, in whole or in part, by another member of the group.[28]

A taxpayer's rebate can be suspended if the taxpayer is delinquent on any state, local, or federal taxes or fees until the delinquency is cured.[29] The rebate may also be recaptured if the taxpayer fails to use the capital investment for at least five years in West Virginia coal production.[30] Recapture is accomplished through imposition of a recapture tax, based on rebates claimed for the taxable year and all preceding tax years that is attributable to the capital investment that has been prematurely removed from service, and the recapture tax is due when the taxpayer's annual return is due for the tax year.[31]

The tax commissioner is authorized to promulgate all necessary rules to carry out the purpose of the rebate program, including emergency rules if filed in the *West Virginia Register* before January 1, 2020.[32] To date, the tax department has not introduced a rule addressing the program.

Unintended Consequence of the Steam Coal Rate Reduction

As noted above, the rebate program is couched in terms of "production," and the measurement for production is the amount of severance tax paid by the producer. The reliance on the amount of severance tax paid to gauge production, rather than actual production volumes, presents an issue for thermal or steam coal producers.

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The issue with the current rebate program language is that it bases an increase in production solely on the amount of severance tax paid by the producer during the base period and the calendar year in which the rebate is being claimed. The amount of the taxpayer's state severance tax is based on the gross value of the amount of coal produced, that is, the sales price of the produced coal and the tax rate applied to the gross value. Thus, regardless of whether a producer's level of production has increased, it may see an increase in severance tax payable based on an increase in the market value of produced coal.

Additionally, a change in tax rate may result in an increase or decrease in the producer's severance tax, regardless of production levels. To that end, the severance tax rate decrease for a steam coal producer will make it difficult for a steam coal producer to take advantage of the rebate program, even if production substantially increases for a steam coal producer, because the base production level is based on the 5 percent severance tax rate imposed on produced steam coal in 2018 and prior years, while the calendar year in which the rebate is claimed will be significantly less than the 5 percent rate.

A steam coal producer could make a significant capital investment in new machinery, equipment, or improvements to real property that results in an increase in produced tons but will be unable to claim a rebate because production levels for purposes of the rebate program are based on the amount of severance tax payable, and the reduced rate will result in no increased production under the rebate program formula.

For more information, please contact any member of the Frost Brown Todd Tax practice group.

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[1] H.B. 3142, 84th Leg., Reg. Sess. (W. Va. 2019).

[2] H.B. 3144, 84th Leg., Reg. Sess. (W. Va. 2019).

[3] W. Va. Code section 11-13A-3(b).

[4] W. Va. Code section 11-13A-3(c).

[5] W. Va. C.S.R. section 110-13AC-1 et seq.

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[6] W. Va. Code section 11-13A-3(i).

[7] W. Va. Code section 11-13A-6a(b)(1). This is essentially a "hold harmless" provision to ensure that the coal-producing counties will not lose their portion of the additional coal severance tax imposed under W. Va. Code section 11-13A-6a as a result of the rate reduction.

[8] W. Va. Code section 11-13EE-2(b)(3).

[9] W. Va. Code section 11-13EE-17.

[10] West Virginia Code section 11-13EE-2(b)(21)(C).

[11] The capital investment, whether machinery and equipment or improvements to real property, must be depreciable or amortizable for federal income tax purposes, and must have a useful life of five or more years. W. Va. Code section 11-13EE-2(b)(3)(B)-(C). Additionally, for the capital investment to be a "qualified investment" it must be "directly used" in the production of coal in West Virginia. W. Va. Code section 11-13EE-2(b)(24).

[12] W. Va. Code section 11-13EE-3(a).

[13] W. Va. Code section 11-13EE-3(b).

[14] "State portion" clarifies that the rebate program will not affect severance tax revenues dedicated to counties or other localities. "State portion of severance taxes paid" means "the portion of severance taxes… when computed at the 4.65 percent rate of tax." W. Va. Code section 11-13EE-2(b)(27).

[15] W. Va. Code section 11-13EE-3(c).

[16] W. Va. Code section 11-13EE-3(d).

[17] *Id.*

[18] *Id.* A taxpayer that operates more than one mine or a taxpayer that is a member of an affiliated or controlled group that operates more than one coal mine shall provide a schedule with its annual severance tax return that shows each coal mine operated in West Virginia, the tons of coal produced at each mine, and the gross value of coal produced at each mine during the taxable year. W. Va. Code section 11-13EE-4. This represents the only reference to "tons of

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coal produced" under the new rebate program, which demonstrates that production, for purposes of the rebate, is based on the amount of state severance tax.

[19] W. Va. Code section 11-13EE-3(e).

[20] W. Va. Code section 11-13EE-2(b)(14)(A).

[21] W. Va. Code section 11-13EE-2(b)(14)(B).

[22] *Id.*

[23] W. Va. Code section 11-13EE-3(e).

[24] W. Va. Code section 11-13EE-5(b).

[25] W. Va. Code section 11-13EE-7(b).

[26] W. Va. Code section 11-13EE-7(c).

[27] W. Va. Code section 11-13EE-10.

[28] W. Va. Code section 11-13EE-6(c).

[29] W. Va. Code section 11-13EE-6(b).

[30] W. Va. Code section 11-13EE-11(a).

[31] W. Va. Code section 11-13EE-11(b)-(c).

[32] W. Va. Code section 11-13EE-14.

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