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STATEMENT OF  
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BEFORE THE  
SUBCOMMITTEE ON COMMERCE, CONSUMER, AND MONETARY AFFAIRS  
HOUSE COMMITTEE ON GOVERNMENT OPERATIONS  
ON [FEDERAL GOVERNMENT EFFORTS TO ADMINISTER THE  
CRUDE OIL WINDFALL PROFIT TAX ACT OF 1980]

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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here to assist the Subcommittee in carrying out its oversight responsibilities. Our testimony today, which deals with Federal Government efforts to administer the Crude Oil Windfall Profit Tax Act of 1980, is based on the work we have done during the past 4 months in response to this subcommittee's request. We have looked into IRS' initial efforts to deal with the Act at the national, regional, and district office level. We have also analyzed the U.S Geological Survey's role in computing, collecting, and accounting for (1) royalty income derived from oil and gas produced on Federal lands and (2) the windfall profit tax levied on Federal oil royalties. Further, we discussed the Act's implications with oil industry representatives.

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The Crude Oil Windfall Profit Tax Act, one of the most significant and complex pieces of tax legislation ever enacted, presents IRS with a major new tax administration challenge. The Act will, if preliminary estimates are accurate, raise over \$227 billion in net tax revenues. Its complex requirements placed substantial administrative burdens on IRS and the oil industry. IRS must assure compliance with the law although it has received no supplemental windfall profit tax administration funding. The oil industry must compute, collect, and pay the tax.

Despite the lack of supplemental funding, IRS has sought to promote voluntary compliance with the new law. It quickly issued temporary regulations and initiated an "early presence" examination program. However, IRS has not yet developed an overall compliance program, integrating all affected Service activities, primarily because no specific official has had day-to-day authority over and responsibility for ensuring accomplishment of that task. One result is that design of a windfall profit tax computerized information support system has been slowed.

Although the Act presented IRS with a massive, new tax administration problem, the Service is not the only Federal agency affected. The Interior Department's Geological Survey is responsible for collecting royalties on oil produced from Federal lands and the related windfall profit tax. Due to serious financial and other management problems, however, Geological Survey may not be collecting millions of dollars in royalties owed the Government. These problems carry through to the windfall profit tax and, as a result, Geological Survey has not been computing or depositing the

tax. Further, until Geological Survey develops significantly better financial management capabilities, it will be hard-pressed to effectively carry out its royalty collection and windfall profit tax duties.

NET RECEIPTS ANTICIPATED  
TO EXCEED \$227 BILLION

Since 1971, most domestically produced crude oil has been subject to mandatory Federal price controls. In 1979, President Carter instituted a program to gradually decontrol crude oil prices. Recognizing that removal of price controls would significantly increase oil industry profits, the Congress passed the Crude Oil Windfall Profit Tax Act of 1980, which the President signed into law on April 2, 1980.

The Act imposes an excise tax on domestically produced crude oil removed from the premises after February 1980. The law contains a "sunset" provision in that the tax will expire on September 30, 1993, or when the Government has collected at least \$227.3 billion, net of allowable deductions and credits, whichever comes first.

On February 20, 1981, the staff of the Joint Committee on Taxation issued a revised estimate of anticipated windfall profit tax revenues. The revision is based on new assumptions about oil production and on updated oil price data, including the effects of President Reagan's January 1981 decision to immediately decontrol oil prices. According to the revised estimates, the Government will have collected \$235.9 billion by the end of calendar year 1990. Thus, the current estimate coincides well with the

congressional estimate of receipts contained in the conference report on the Act.

According to Treasury Department excise tax statistics issued in March 1981, the oil industry reported deposits of at least \$6.8 billion in windfall profit taxes with the Department during calendar year 1980. Originally, the Congress estimated that gross collections for calendar year 1980 would total \$10.9 billion. At first glance, there seems to have been a significant shortfall in windfall profit tax collections. For at least two reasons, however, the \$6.8 billion collection statistic may be inaccurate.

First, IRS has not yet processed all calendar year 1980 excise tax returns. This is because taxpayers were not required to file excise tax returns with respect to the quarter ending December 31, 1980, until February 28, 1981. Until those returns have been processed, IRS cannot determine the exact amount of windfall profit tax deposited with Treasury in 1980. Second, oil purchasers were not required to furnish taxpayers with annual statements of total windfall profit tax withheld until March 31, 1981. Once taxpayers have received that information, they may find that the correct amount of tax was not withheld. Thus, they may have to pay additional tax or file for a refund.

Given the newness and complexity of the law, it seems reasonable to expect some withholding inaccuracies. Thus, it is too early to determine the extent of the shortfall, if any. It is not, however, too early to state that complying with the

complex requirements of the Act has proven burdensome for all affected parties.

WINDFALL PROFIT TAX ADMINISTRATION  
IS BURDENSOME FOR IRS AND THE OIL  
INDUSTRY

Chart A, now before you, illustrates the complexity of the Act in showing how producers, operators, and withholding agents must interact with IRS and each other under the windfall profit tax system. Producers are individuals and business entities who own an interest in an oil-producing property. Operators are those who actually extract the oil from a property. Withholding agents--generally the first purchasers of oil--compute and withhold the windfall profit tax attributable to the sale.

The process begins with the operator of an oil-producing property. The operator must determine the tier of oil being extracted and the kinds of producers who hold interests in the property. There are 3 different oil tiers, graduated, generally, on the basis of (1) the "windfall" element and (2) an incentive aspect to encourage new production. Also, there are 4 main kinds of producers--integrated oil companies, independent producers, royalty owners, and tax-exempt parties. The windfall profit tax rate is determined through a matrix of oil tiers and producers. The property operator must certify to the withholding agent the tier of oil being produced and the kinds of producers having interests in the property. Providing the latter information is not an easy task because hundreds of parties can have fractional interests in a single property. However, unless this information is made available to the withholding agent and IRS, the highest possible windfall profit tax rate usually will be applied.

Generally, producers use form 6458 to certify their status.

There is no standard form for certifying oil tier.

When oil is actually produced and sold, the withholding agent receives an invoice from the operator. The withholding agent must compute and withhold the windfall profit tax, based on the certified information provided by the operator. Chart B, now before you, illustrates (1) how a withholding agent computes the tax and (2) the kinds of information the agent needs to make an accurate calculation. The chart depicts the windfall profit tax calculation for one barrel of stripper oil produced by an integrated oil company. This is, of course, but one example; many variations of the calculation are possible depending on the tier of the oil, its removal price, the kind of producer involved, and the State in which the oil is produced.

Having computed the tax, the withholding agent pays the operator for the oil but withholds the tax from that payment. The operator then redistributes the net check among the various producers. Meanwhile, the withholding agent deposits the tax dollars withheld with the Treasury. Integrated oil companies are required to deposit taxes withheld twice a month; independent oil companies need only make deposits every 45 days. Regardless of deposit requirements, withholding agents must account for amounts paid into the Treasury on a quarterly basis via excise tax return form 720, together with windfall profit tax accounting form 6047.

Annually, the withholding agent prepares an information return, form 6248, for each operator, summarizing windfall profit tax withholdings. The withholding agent sends copies of the

form 6248 to the operator and IRS. The operator uses this form 6248 as a means for notifying each producer of the windfall profit tax amount that has been withheld. The operator does so by preparing individual form 6248s for each producer and sending copies of each form to IRS.

The tax withheld may exceed the actual liability because the law includes a provision to ensure that the tax does not render oil production unprofitable. That provision is referred to as the net income limitation. Basically, the windfall profit on a barrel of crude oil is limited, by law, to 90 percent of the net income attributable to that barrel. For this reason, a year-end refund may be due.

To illustrate, chart C recomputes the actual windfall profit tax liability on the barrel of oil depicted earlier in chart B. As shown, given that production costs were \$30, the producer's actual tax liability is \$5.40, rather than the \$10.80 withheld by the agent. To retrieve the difference, the producer must file with IRS for a refund. Similarly, if the purchaser has underwithheld the tax, the producer must file an excise tax return and pay the difference between the amount withheld and the actual liability.

Producers should compute their windfall profit tax liability before filing an income tax return. This is because the windfall profit tax is deductible on individual and corporate income tax returns and thus reduces the producer's income tax liability. Also, royalty owners presently are entitled to claim a windfall profit tax credit of up to \$1,000 against their income tax liability.

We think the charts before you clearly demonstrate the complexity of this tax. The charts also indicate the unique nature of the tax and give some insight into the problems IRS faces in administering it. These problems have been compounded by the fact that IRS has received no supplemental funding for windfall profit tax administration. Notwithstanding the lack of funding, IRS has decided to pursue windfall profit tax administration vigorously. In light of the potential revenues involved, that decision is appropriate. On the other hand, that decision has implications for other IRS programs. In February 1981, IRS estimated that it would spend 877 staff years and \$20 million in fiscal year 1981, and 1,056 staff years and \$24 million in fiscal year 1982, to administer the tax. These resources must be diverted from other IRS programs and, as a result, other programs will suffer. The diverted staff years themselves, while significant in number, understate if anything the impact of the reassignments on IRS' other programs since it will be drawing on its more experienced and skilled employees to deal with these complex matters.

Moreover, the need to carry out many windfall profit tax return examinations will accelerate the trend toward a lower audit coverage level. In fiscal year 1976, IRS audited 2.59 percent of returns filed. By fiscal year 1980, audit coverage was down to 2.12 percent of returns filed. In fiscal year 1982, IRS expects to be able to audit only 1.83 percent of returns. To partially remedy that decline, however, the Secretary of the Treasury recently announced that some existing IRS resources may be shifted from other IRS activities, such as Taxpayer Service, to compliance activities, such as examinations. While this might alleviate some of the anticipated effects of windfall profit tax administration, it will produce other effects, namely a decline

in IRS' ability to assist taxpayers who seek to comply with the tax laws.

We understand the importance of ongoing efforts to balance the Federal budget. However, the lack of supplemental funding for windfall profit tax administration will inevitably affect other compliance programs. This is of particular concern in light of the precarious nature of our voluntary compliance tax system, as evidenced by IRS' 1979 report on unreported income, extensive hearings on the subterranean economy held by this subcommittee, and recent, heavily publicized tax protester activities. Those activities are the subject of hearings to be held by this subcommittee in the near future.

In any case, despite the lack of supplemental funds, IRS has made some progress toward developing a windfall profit tax compliance program.

IRS HAS ESTABLISHED AN EARLY  
COMPLIANCE PRESENCE THROUGH  
ITS EXAMINATION PROGRAM

Once the law was enacted, IRS quickly began various activities. Recognizing at the outset that windfall profit tax administration would differ significantly from existing programs, IRS

- issued initial regulations and has since revised and supplemented them several times,
- initiated an extensive windfall profit tax training program based in part on experience gained from 7 test audits, and
- developed and has begun implementing a plan for selecting and examining windfall profit tax returns, with a

view toward establishing an early IRS enforcement presence.

On April 4, 1980, two days after the Act became law, IRS issued temporary regulations providing compliance guidelines to producers, operators, and purchasers of domestic crude oil. IRS received hundreds of pages of comments on the regulations, evaluated those comments, and has since amended and supplemented the regulations several times.

In doing so, IRS opened and has maintained an active dialogue with the oil industry. For example, many oil company representatives told IRS that the regulations' initial definition of a "first purchaser" was too narrow, unclear, and did not always mesh with standard industry practice. IRS evaluated those complaints and found that many first purchasers did not always have the information needed to accurately compute the tax. IRS then broadened the definition--to allow industry greater flexibility in deciding who could act as the tax withholding agent--thus easing the administrative burden on industry while also enhancing voluntary compliance with the law.

Maintaining effective communication with oil industry representatives may prove crucially important to IRS. The Service had to adopt, on a wholesale basis, many Department of Energy regulations in order to quickly begin its windfall profit tax administration system. Unfortunately, many of the basic definitions contained in the Department of Energy regulations have been challenged in court. Depending on how these lawsuits are resolved, they could affect IRS' tax administration program, as discussed in our report entitled "Department of Energy Needs to Resolve

Billions in Alleged Oil Pricing Violations" (EMD-81-45, Mar. 31, 1981). In that report, we recommended that the Commissioner of Internal Revenue evaluate the potential effects of these lawsuits on IRS' program, with a view toward taking quick corrective action as necessary. This is but one example of the unique problems IRS faces in seeking to administer the new law.

Although the windfall profit tax is by definition an excise tax, its structure and computation more closely resemble an income tax. IRS has recognized that traditional excise and income tax procedures will not be adequate for administering the windfall profit tax because of the unique way in which the tax is imposed upon the petroleum industry.

Most excise taxes are computed on the basis of a flat percentage or monetary rate, which is applied to verifiable production or sales units. The windfall profit tax, on the other hand, although applicable to verifiable production units is not flat, but is computed on a property-by-property basis and involves numerous variables. Its complexity rules out use of traditional excise tax return compliance procedures. Similarly, traditional income tax return compliance procedures cannot be applied wholesale to windfall profit tax administration, for various reasons. For example, the parties responsible for paying the tax--producers--often may not have to file excise tax returns with respect to the windfall profit tax. Moreover, producers do not generally maintain the records needed to determine their tax liability. Rather, operators maintain those records and, in some instances, actually file returns. In other instances, however, operators provide information to first purchasers who, in turn, file tax returns with respect to producers' tax liability.

IRS has found it necessary to focus its examinations on withholding agents and operators. During these examinations, IRS plans to identify producers who own an interest in a property, but who have not filed returns. This strategy requires that IRS deal primarily with sophisticated taxpayers in an industry having specialized operating and accounting practices. IRS, therefore, has decided that it can use only experienced revenue agents, engineers, and computer audit specialists in conducting windfall profit tax examinations. Having made that decision, IRS recognized the need to develop and deliver specialized windfall profit tax training programs.

Fortunately, IRS' Southwest Region began to formally develop petroleum industry expertise (for income tax examinations) about two years before enactment of the windfall profit tax. Specifically, in late 1978, the Service organized the Petroleum Industry Program in the Southwest Region. The program was designed to give special attention to the tax implications of the structuring and restructuring of the petroleum industry. Due to the expertise gained through that program, IRS' Southwest Region was delegated much of the early responsibility for developing plans for implementing a windfall profit tax compliance program.

The region's training package was completed in June 1980. Since then, the region has trained approximately 475 of its employees. Of these 475 employees, about 400 were revenue agents with the balance composed of employees from other IRS program areas such as collections, appeals, and criminal investigations. IRS then had to implement its "early presence" theory by working

trained agents into windfall profit tax examinations as quickly as possible.

In September 1980, IRS began examining 7 first purchasers' quarterly returns--all within the Southwest Region. These "test" examinations were begun to establish an initial IRS presence and to provide experience for use in refining training materials and developing examination guidelines. Until recently, these test cases were the only windfall profit tax examinations begun by the Service, primarily because the bulk of IRS' training effort was concentrated in the first two months of calendar year 1981. Since then, the volume of open cases increased significantly. As of early March 1981, the region had begun examining the returns of over 100, or 20 percent, of the Nation's estimated 500 first purchasers..

On the other hand, with few exceptions, examinations directed at the Nation's estimated 16,000 oil property operators have yet to begin. These examinations--to be selected based largely on information obtained during first purchaser audits--are tentatively scheduled to begin this month. Operator-level examinations will be a critical part of the Service's examination program, because the operator is the one who must certify the key tax determination elements--base price, oil tier, and the property description.

In total, IRS plans to initiate some 1,950 audits in fiscal year 1981 involving 265 first purchasers and 1,685 operators. These statistics equate to approximate audit coverage levels of 50 percent for first purchasers and 10 percent for operators.

IRS' Southwest Region--which consists of 8 States--will have by far the most significant windfall profit tax administration role. Texas, Oklahoma, and Louisiana alone account for over 50 percent of the Nation's domestic oil production. Further, based on Department of Energy data, approximately 82 percent of the Nation's petroleum operators and 37 percent of the oil purchasers are located in the Southwest Region.

The Service also expects to audit about 3 percent of the producer universe in fiscal year 1981. However, more experience is necessary to determine the actual number of producers. IRS estimates there are some 1.1 million producers who, because of sales to multiple first purchasers, will receive some 4 million annual withholding information forms. Other estimates have ranged considerably higher.

Additionally, IRS estimates that some 600,000 royalty owners will be eligible for the one-time tax credit (up to \$1,000 each) provided by the Revenue Adjustment Act of 1980. The Service plans to review some returns containing that credit. Finally, the Service plans to select about 100 tertiary recovery oil certifications for detailed review.

IRS believes these first year coverage levels will be necessary to effectively promote voluntary compliance with the law. It has made progress in examining first purchasers' returns. But, other equally critical examinations--that is, those at the oil property operator level--have not yet been initiated. Moreover, there is a need for an integrated compliance program. Developing and implementing an overall compliance strategy, which integrates all the Service's functions, is a formidable task.

IRS NEEDS TO QUICKLY DEVELOP A  
COMPREHENSIVE WINDFALL PROFIT  
TAX COMPLIANCE STRATEGY

Although IRS has made progress, it still faces many problems. Through its "early presence" examination program, IRS has gained a foothold on effective windfall profit tax compliance. Examinations, however, comprise but one aspect of a compliance program. It is imperative that IRS quickly develop and implement a comprehensive strategy. Thus, beyond examinations, IRS needs to concern itself with other compliance activities such as collections, criminal investigations, and appeals. It has not yet done so, primarily because no specific official has had the day-to-day authority over and responsibility for ensuring accomplishment of that task. One result is that the design of a computerized windfall profit tax information system has been slowed. A possible means for resolving this problem would involve appointing a project manager to develop and implement a comprehensive windfall profit tax compliance strategy.

In April 1980, when the law was passed, IRS established a multifunctional national office task force headed by a project manager detailed from its Southwest region. The task force quickly conceptualized an interim compliance plan approach and outlined in very broad terms a recommended strategy for dealing with this new tax administration challenge. The task force submitted its report in September 1980 and, in accordance with IRS plans, the project manager gradually began relinquishing his special responsibilities. Basically, IRS wanted to begin using its

existing organizational structure to implement the task force recommendations. Since then, however, progress has been slow.

The task force recommended that various IRS functions carry out numerous tasks. For example, the task force noted that the Examination Division needed to determine how to select returns for audit; the Collection Division needed to determine how to detect non-filers; and the Appeals Division needed to determine how its processes could be applied to multiple producers having interests in a single property.

Since September 1980, however, no specific IRS official has had day-to-day authority over and responsibility for ensuring that (1) tasks were carried out and (2) an effectively coordinated compliance strategy was developed. True, IRS' Assistant Commissioner for Compliance chaired a control group, composed of senior IRS managers, whose responsibility included assuring development of an overall compliance strategy. These top managers, however, have multiple responsibilities and could not be expected to personally direct the project on a daily basis.

Instead, each function has been expected to carry out its assigned tasks under normal managerial and supervisory controls. Implementing the task force plan, however, involves many functionally interdependent tasks. Unfortunately, accomplishment of a task by one IRS function has sometimes been hampered or prevented pending decisions from other IRS functional areas or other groups in the same functional area. These problems are best illustrated by the difficulties IRS has faced in seeking to define requirements for a windfall profit tax computerized information system.

To effectively manage a windfall profit tax compliance program, IRS will need a computerized information system that can provide the data needed by each of IRS' functional activities. IRS recognized that fact early-on, yet there have been significant delays in defining system requirements. This problem is compounded by the long lead time required to develop and implement an information processing system. The longer IRS takes to make key decisions, the longer it will go without vital computer support.

Current IRS plans call for development of a computerized information system in two phases--interim and permanent. The interim system, a stopgap measure, will not be fully operative until late 1981. The permanent system will not be operative until 1983, at the earliest.

The interim system is being designed by IRS personnel and will be operated on existing IRS computers. That system will accumulate, maintain, and print out limited data in support of certain windfall profit tax compliance activities. For the most part, outputs from the interim system will consist of listings from the various forms discussed earlier. Specifically, the system is expected to

- consolidate related cases thus enabling IRS to avoid premature issuance of statutory notices of deficiency,
- consolidate and print out information from annual windfall profit tax withholding documents on an individual producer basis,

- consolidate and print out windfall profit tax refund claim information,
- check the validity of some of the certifications filed, and
- help IRS identify some non-filers.

The final form of the interim system remains unknown, however, because certain IRS user groups have not defined their specific requirements. This in turn has prevented IRS from integrating various user needs into a single system.

For example, a January 1981 Examination Division request for extracts of data from other automated IRS files lacked clear descriptions of information processing requirements. The request must be clarified before IRS' Data Services Division can take action. Also, the Collection Division requested that Data Services develop a matching process for certification forms and excise tax returns. Data Services rejected that request because, due to other priorities, it could not provide the needed programming support for the proposal. Moreover, in November 1980, IRS' Taxpayer Service Division requested that Data Services design a method for transcribing information contained on annual withholding documents. As of March 1981, however, other users of the data to be transcribed, such as IRS' Statistics Division, had not told Data Services how to format printouts of the information.

IRS faces even greater technical problems in seeking to define requirements for the more sophisticated permanent system.

Specifying the content of the system and the relationships between various pieces of data requires even more extensive coordination and communication among various IRS user groups. Many key decisions have not been made and, as a result, the system will not soon be operative. Thus, IRS will have to depend on its stopgap system longer than it would like.

IRS has outlined the general characteristics and capabilities that need to be included in the permanent system. For example, the system is expected to

- accumulate, consolidate, and process windfall profit tax data, and provide output to be used by IRS' various functions;
- incorporate both excise and income tax return information;
- include a document matching capability with respect to various windfall profit tax returns and forms as well as certain related forms;
- provide IRS with a statistical research capability.

Before IRS contracts for the permanent system, however, it needs to determine (1) what pieces of data to transcribe from the various tax forms, (2) how various pieces of data will be linked together, (3) which information to consolidate, match, compare, list, etc., (4) how to number oil properties for control purposes, (5) how to control partnership returns, and (6) the format of specific system outputs. These are but a few examples of decisions that need to be made.

Significantly, however, such key decisions have not been made. That is the reason why the permanent system cannot be operative until mid-1983 at the earliest. And, unless some hard

decisions are made soon, the system may not be operative then. Originally, IRS hoped to issue a "request for proposal" for development of the hardware and software components of the permanent system in January 1981. In early March 1981, IRS' Assistant Commissioner for Data Services told us that the Service hoped to get the request out by June. On April 6, 1981, however, a special assistant to IRS' Assistant Commissioner for Compliance told us that IRS was reconsidering the need for the permanent system. The special assistant said that he plans to present another alternative proposal--which involves expanding the interim system--to the control group in the near future. The special assistant said that the revised system under consideration could be operational late this calendar year.

In any case, more than a year after passage of the Act, IRS is still trying to finalize the scope of the computerized wind-fall profit tax information support system. Until that decision is made, other key decisions must be put off. For example, IRS has to

- decide what data to capture from the various forms;
- decide how pieces of data can best be linked together and what technical linkage mechanism ought to be used;
- determine what data it will consolidate, match, compare, and/or list to best meet users' needs;
- decide how the system will control data on a property-by-property basis;
- determine how the system can best control cases, especially for partnership returns; and

--specify the format of system outputs so that they provide meaningful assistance to various user functions.

The difficulties IRS has faced in seeking to develop a system are understandable. IRS has had to deal with a new and complex program affecting all parts of the organization. We have noted similar problems in the past with respect to other systems development efforts.

In our June 1979 report, entitled "IRS Can Better Plan For And Control Its ADP Resources" (GGD-79-48, June 18, 1979), we suggested that IRS consider adopting a project manager approach to major systems development efforts. IRS' Internal Audit Division made a similar recommendation that same year. A project manager with the requisite authority over and responsibility for systems development could make key decisions, develop and carry out plans, and provide day-to-day direction, coordination, and control over the project. In sum, we stated in our earlier report that the project manager concept is a "sound management practice that would improve control and accountability during the systems development process." To be effective, a project manager within IRS would need (1) authority to cross functional lines, (2) a separate budget for the task at hand, and (3) ready access to the Commissioner or Deputy Commissioner.

Although our earlier report dealt primarily with computer systems development projects, it is relevant to the windfall profit tax compliance program in general. Developing an overall compliance program requires identifying, consolidating, and implementing distinct but interrelated IRS user needs. This

formidable task, however, requires management skills as opposed to purely technical, computer-oriented skills. A manager charged with this responsibility would, of course, need support from expert computer-oriented employees. The manager's primary responsibility would, however, center on coordinating and controlling the activities of many different functional specialists with a view toward (1) developing an overall windfall profit tax compliance strategy and (2) defining the specific requirements of the essential computer support system for that program.

In light of the size of the revenues at stake, the need to quickly build on the benefits derived from IRS' early examination program, and the clear need for quick development and implementation of an overall compliance program with sophisticated computer system support, IRS should consider appointing a project manager for windfall profit tax administration matters. The project manager, given appropriate authority, could serve as a catalyst for actions needed to further IRS' windfall profit tax compliance efforts.

Clearly, IRS faces extraordinary problems in seeking to administer the Crude Oil Windfall Profit Tax Act. IRS, however, is not the only Federal agency that has had to deal with the new law. The Interior Department's Geological Survey, which is responsible for collecting the windfall profit tax on oil produced from Federal lands, also faces problems.

U.S. GEOLOGICAL SURVEY IS ILL-EQUIPPED  
TO COLLECT FEDERAL ROYALTIES AND THE  
RELATED WINDFALL PROFIT TAX

The U.S. Geological Survey is responsible for collecting the royalty income the Federal Government derives from oil and gas produced on Federal and Indian lands. Since April 1980, it also has had responsibility for computing and depositing a part of the windfall profit tax levied against oil produced on Federal lands; oil produced on Indian lands is exempt from the windfall profit tax.

In our 1979 report entitled "Oil and Gas Royalty Collections-- Serious Financial Management Problems Need Congressional Attention" (FGMSD-79-24, Apr. 13, 1979), we pointed out that Geological Survey was having great difficulty in accounting for and collecting Federal royalty income. On the basis of more recent work, we have determined that these problems not only persist, but have been compounded by an increasing workload including the added administrative burden associated with the windfall profit tax.

Geological Survey is not collecting all oil and gas royalties and, as a result, hundreds of millions of dollars owed the Government may be going uncollected each year. Moreover, millions of dollars in royalty income are not collected when due, thus increasing the Government's interest costs. Geological Survey's inability to accurately assess and collect Federal royalties also affects collection of the windfall profit tax associated with those royalties. In order to accurately compute and deposit that tax, royalties must first be accurately computed and collected. Until Geological Survey improves its financial

and other management capabilities, there can be little assurance that the Government is receiving all the royalty income and tax revenues due from Federal lands. This deficiency is especially significant in view of Geological Survey's increased windfall profit tax responsibilities.

We recognize that Geological Survey's task is complex and that it has had to deal with many factors beyond its control such as the proliferation of lease interests, varying royalty rates, and complex oil and gas valuation factors. Moreover, the monetary amounts Geological Survey is responsible for have grown tremendously in recent years, primarily due to rising prices. For example, in calendar year 1977, Geological Survey collected about \$1.2 billion in royalties. In fiscal year 1984, Geological Survey estimates that it will collect about \$11 billion.

Geological Survey is seeking to improve its financial management capabilities by developing a more sophisticated computer system. That system, however, will not help the agency determine and collect previously uncollected royalties and determine the windfall profit tax due on those royalties. Geological Survey needs to develop a separate plan to deal with that problem.

Geological Survey has not computed  
or deposited the windfall profit tax

Geological Survey had limited responsibilities for computing and depositing the windfall profit tax on oil royalties generated from Federal lands from March 1, 1980, to March 31, 1981. At its own request, it was given even more significant responsibilities beginning April 1, 1981. In light of its longstanding problems

in collecting royalties, Geological Survey may not soon be able to carry out its expanded duties.

Federal and Indian lands account for a substantial portion of the Nation's oil and natural gas reserves. In fiscal year 1980, 14 percent of the Nation's domestic crude oil and 29 percent of the natural gas were produced on Federal or Indian lands. That production was valued at \$17.6 billion and it generated about \$2.7 billion in Government and Indian royalties.

The Federal Government usually receives one-eighth of the revenues generated from the sale of oil produced from onshore Federal lands in the form of royalty payments; it usually receives one-sixth of the revenues generated from the sale of oil produced offshore. The Federal Government shares its onshore royalty income with the States; it does not share offshore royalty income. The windfall profit tax levied against the Federal Government is deducted from Federal royalty revenues.

Temporary IRS regulations, issued on April 4, 1980, charged Geological Survey with responsibility for computing and depositing the windfall profit tax applicable to royalty revenues for oil produced on Federal lands and removed from the lease premises prior to sale. Geological Survey was not responsible for collecting the windfall profit tax owed by leaseholders and others holding an interest in the leaseholds of Federal lands, nor for the windfall profit tax applicable to royalty revenues where this oil was sold prior to removal from the premises. Thus, Geological Survey had to deal with only a small portion of the total windfall profit tax

attributable to oil produced on Federal lands; non-governmental withholding agents handled the rest, as presented earlier in chart A.

Geological Survey estimated that the windfall profit tax payable on the Government's royalty income from oil produced on Federal lands, during the six months ending September 30, 1980, totaled \$221 million. The accuracy of that estimate, however, is unknown because it was based on limited data supplied by oil companies.

Regardless of the accuracy of the \$221 million estimate, Geological Survey has not computed or deposited the windfall profit tax. To compute the tax, Geological Survey needs certain data from the oil companies, such as oil tier category and base price information. It has asked for, but has not yet received, all the necessary data from the oil companies.

Revised IRS regulations, issued in January 1981, charged Geological Survey with the additional responsibility of computing and paying the windfall profit tax applicable to all royalties paid the Federal Government. Geological Survey has estimated that it will need an additional 100 employees to handle its expanded windfall profit tax responsibilities. Meanwhile, in an attempt to deal

with these responsibilities, Geological Survey planned to take the following actions:

--Beginning in April 1981, from 45 to 50 percent of Federal royalties collected will be deposited into a Treasury suspense account. The suspense account will be cleared when the quarterly form 720 is filed with IRS.

--By June 30, 1981, Geological Survey hopes to have calculated and deposited with Treasury all windfall profit tax not yet paid on fiscal year 1980 royalties.

These steps, while positive, will not completely solve Geological Survey's problems in dealing with its windfall profit tax responsibilities. Of more fundamental concern, however, is Geological Survey's ability to even assure that royalties due are actually paid.

Persistent management problems prevent accurate computation and collection of oil and gas royalties

Since 1972, numerous General Accounting Office and Department of Interior audit reports have pointed out the need for improved management of Geological Survey's royalty collection system. These reports have pointed up the possibility that hundreds of millions of dollars are not being collected. For example, in our April 1979 report, we noted that Geological Survey was not collecting all the oil and gas royalty income due the Federal Government because

--lease account records contained numerous errors and omissions,

--unverified data was used to compute royalties, and

--collection procedures were inadequate.

Although Geological Survey has sought to respond to some of the recommendations contained in our report, management problems persist. Accurate computation of the windfall profit tax due on oil royalties depends on the accuracy of royalty computations.

In our 1979 report, we stated that Geological Survey's lease account records contained numerous errors and data omissions and could not be relied on to determine the accuracy of royalty collections. As a result, the Survey and the oil and gas industry cannot use these records to determine if royalties were properly computed and paid.

The Geological Survey maintains lease account records for oil and gas leases on Federal and Indian lands. Royalties earned and payments made are recorded in the lease accounts maintained by the Survey's computer using data reported by the oil and gas companies. If the recorded amounts due the Government and the royalties paid do not agree with each other, the computer, rather than clearing the account, will show a balance. Account balances normally result when the companies

- make an error in computing the amount of royalties owed or amounts paid,
- make an error in reports submitted and used to compute royalties owed or in paying royalties due,
- fail to pay royalties owed, or
- fail to report the data used to compute and record royalties owed or paid.

However, the Geological Survey can also create erroneous account balances by recording charges or payments in the wrong account and by making other clerical errors.

On July 31, 1978, the Geological Survey maintained 22,735 lease accounts. Of these accounts, only 6,569 did not have a balance. Of the accounts with a balance, 9,497 indicated that the amount paid was greater than the royalties due the Government. Although this condition can result from overpayments to the Government by the oil and gas companies, it occurred more frequently because royalties due the Government were understated when company reports were not received and charges were not properly entered in the accounts. The balance of these 9,497 accounts was \$49.8 million. The remaining 6,669 accounts indicated that royalties of \$38.8 million were due because the amount collected was less than the amount computed as due.

To determine the accuracy of these accounts, we reviewed 714 randomly selected lease accounts for June, July, and August 1977. We noted the following deficiencies which contributed to the inaccuracy of these basic accounting records.

--In 137 cases, royalty payments totaling \$258,000 were recorded in the accounts without corresponding amounts being recorded as due.

--In 245 cases, royalties totaling \$471,000 were recorded as due without corresponding royalty payments being recorded.

--In 469 cases, the royalties due did not equal the royalties paid. Royalties paid exceeded the amounts recorded as due by \$122,000.

On the basis of more recent follow-up work, we determined that lease accounts still are inaccurate. As of September 1980, 19,487 or 73 percent, of Geological Survey's 26,769 lease accounts had a balance. Of these, 9,962 accounts indicated that

Geological Survey had been underpaid by \$134 million; the remaining 9,525 accounts indicated, for the most part erroneously, that Geological Survey had been overpaid by \$153 million.

Our follow-up analysis of 280 of the 714 lease accounts we had previously analyzed, for the three months ending June 30, 1980, showed that

--In 115 cases, royalty payments totaling \$125,336 were recorded in the accounts without corresponding amounts being recorded as due.

--In 97 cases, royalties totaling \$276,569 were recorded as due without corresponding royalty payments being recorded.

--In 174 cases, the royalties due did not equal the royalties paid. Royalties paid exceeded the amounts recorded as due by \$119,226.

Because of the incomplete and inaccurate data entered in these accounts concerning royalties paid and royalties due, these account statements could not be used to adequately manage royalty collection activities. Moreover, Geological Survey relied almost entirely on unverified data in seeking to calculate royalty amounts due.

Geological Survey relies almost entirely on production and sales data reported by oil and gas companies to compute royalty payments due. It makes little effort to verify the accuracy of the data supplied. In fiscal year 1980, Geological Survey audited only 5 percent of its lease accounts although past audits have proven cost-effective. For example, as discussed in our

1979 report, Geological Survey's Metairie, Louisiana office completed eight audits during the 9-month period ending September 30, 1978. Those audits yielded \$7.5 million in additional Federal royalty income.

Geological Survey could reduce its reliance on unverified data by matching reported production data against reported sales data. By doing so, Geological Survey could identify potentially serious data inconsistencies which indicate possible royalty payment shortfalls. Moreover, this approach could be further refined by having Geological Survey personnel, who periodically inspect well sites, verify reported production data. However, better data verification procedures alone will not resolve all of Geological Survey's financial management problems. It also needs to improve its royalty collection techniques.

In our prior report, we noted that, in 1977, Geological Survey did not collect about \$359 million in royalty payments when they were due. Payments were not received within the timeframes specified in leases because Geological Survey

--did not adequately enforce lease provisions calling for timely payment of royalties, and

--did not impose appropriate administrative fees or interest charges on those making late payments.

Based on our analysis of 280 lease accounts for the three months ending June 30, 1980, we project that, for the universe of lease accounts, late payments totaled \$102 million for that quarter alone. Had these delinquent payers been assessed interest charges equal to the cost of Federal borrowing, they would have owed an additional \$400,000 for the 3-month period alone. Unfortunately, Geological Survey did not take timely action on this problem, despite our earlier report.

In our prior report, we recommended that procedures be established to charge interest on late payments. Geological Survey, however, has been slow in implementing this recommendation. Interest was not charged on late payments applicable to offshore leases until September 1980. Further, procedures for charging interest on late payments made by onshore lease holders were not issued until December 1980, with an effective date of February 1981. However, because of the existing freeze on new regulations, implementation of the procedures has been delayed. Recently, Geological Survey requested and received an exemption from the freeze. It now plans to assess interest on all late payments received after March 31, 1981.

Geological Survey is making an effort to correct its financial management problems

In our 1979 report, we cited evidence indicating that Geological Survey may not have been collecting as much as 7 to 10 percent of the royalty amounts owed the Federal Government. Currently, Geological Survey, by its own admission is not collecting over \$1 million per day in royalties.

Geological Survey, recognizing that its accounting system was inadequate, formed a task force in October 1978 to recommend system improvements. In December 1978, the task force recommended that a new royalty accounting system be designed and implemented. That system is not yet operational and will not be fully operational for several years.

Geological Survey completed a feasibility study and cost/benefit analysis for a new system in March 1981. It plans to

award a contract for the new system in September 1981. The system will be implemented in three phases over a 5-year period. The three phases consist of (1) the royalty accounting phase, (2) the production phase, which will permit the matching of production and sales data, and (3) the enhanced management phase which centers on development of cost accounting and quality review data.

Geological Survey currently estimates that the royalty accounting phase will be fully implemented in fiscal year 1983, and the production phase by 1985. If the system is effective, Geological Survey should be able to better compute royalty payments due. Further, the system should enable Geological Survey to accurately compute and deposit the windfall profit tax on Federal royalty payments. Until then, however, it seems that Geological Survey will be hard-pressed to carry out its various responsibilities. Moreover, the new system, when implemented, will do little to help Geological Survey address the reconciliation of existing lease account balances which have been steadily increasing and the problem of uncollected royalties. Geological Survey does not plan to transfer existing account balances into the new royalty accounting system. Thus, besides actively working to develop the new system, Geological Survey also has to develop a plan for reconciling old accounts and identifying and collecting previously uncollected royalties.

Specifically, Geological Survey needs to determine how it can most effectively and efficiently accomplish these tasks. This determination should also address the resources that will be needed and it must establish milestones for completion of the

tasks. Accountability is needed because previous progress has been slow. Based on this analysis, Geological Survey, through the Interior Department, should submit an appropriate budget proposal to the Office of Management and Budget for consideration. In light of Geological Survey's statutory responsibilities and the potential revenues involved, Geological Survey ought to be able to adequately justify a request for additional staff and funds for this project.

Moreover, Geological Survey has indicated in the past that staffing and budget shortages have contributed to its financial management difficulties. For example, the agency has stated that it needs authority to hire more auditors. The evidence tends to support that contention. The agency, however, has not been able to convincingly demonstrate its specific additional resource requirements. To do this, it must define more explicitly what needs to be done that cannot be done with its existing resources.

This concludes my prepared statement. We would be happy to respond to any questions.



# WINDFALL PROFIT TAX WITHHOLDING COMPUTATION

REMOVAL PRICE <sup>1/</sup> ... \$40.00

LESS:

ADJUSTED  
BASE PRICE <sup>2/</sup> ... \$20.00

STATE  
SEVERANCE  
TAX

ADJUSTMENT <sup>3/</sup> 2.00      22.00

WINDFALL PROFIT ..... 18.00

WINDFALL PROFIT  
TAX RATE <sup>4/</sup> ..... 60%

WINDFALL PROFIT  
TAX WITHHELD ..... \$10.80

## NOTES

<sup>1/</sup> USUALLY EQUIVALENT TO THE SELLING PRICE

<sup>2/</sup> THE ADJUSTED BASE PRICE IS THE UNCONTROLLED BASE PERIOD PRICE MULTIPLIED BY THE APPLICABLE TIER MULTIPLIER AND ADJUSTED BY THE QUARTERLY INFLATION FACTOR

<sup>3/</sup> ASSUMES A 10 PERCENT SEVERANCE TAX RATE, WHICH IS APPLIED TO THE DIFFERENCE BETWEEN THE REMOVAL PRICE AND THE ADJUSTED BASE PRICE

<sup>4/</sup> VARIES DEPENDING ON THE OIL TIER AND THE PRODUCERS' STATUS

# NET INCOME LIMITATION COMPUTATION

REMOVAL PRICE ..... \$40.00

LESS: PRODUCTION  
COSTS <sup>1/</sup> ..... 30.00

TAXABLE INCOME \$10.00

NET INCOME  
LIMITATION <sup>2/</sup> ..... 90%

NET INCOME  
LIMITATION  
PER BARREL ..... \$9.00

WINDFALL PROFIT  
TAX RATE ..... 60%

WINDFALL PROFIT  
TAX LIABILITY ..... \$5.40

## NOTES

<sup>1/</sup> VARIOUS EXPENSES MAY BE TAKEN INTO ACCOUNT IN DETERMINING THESE COSTS

<sup>2/</sup> AS SPECIFIED BY LAW