



## **Credits & Incentives talk with Deloitte**

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producers in a low-price environment

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*CREDITS & INCENTIVES TALK WITH DELOITTE*

## Tax Credits and Incentives for Oil & Gas Producers in a Low-Price Environment

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Given the generally low-price environment, oil and gas producers have focused renewed attention on cost reduction, management of their global tax burden and improving cash flow. Utilization of available federal and state tax incentives, exemptions and exclusions to reduce federal and state tax burdens is one way companies in the oil and gas industry can seek to accomplish these goals. To this end, the U.S. and state

governments continue to provide tax incentives for eligible oil and gas companies to encourage domestic oil and gas exploration and recovery during periods of low commodity prices. These incentives may prove to be particularly valuable in the current low-price environment.

This article will focus on some of the federal and state tax benefits potentially available to oil and gas producers in the current low-price environment.

## Federal tax credits

For federal income tax purposes, there are several provisions in the Internal Revenue Code which seek to incentivize oil and gas production, specifically the marginal well tax credit and the enhanced oil recovery credit.

**Federal marginal well tax credit:** In 2004, Congress enacted a marginal well production tax credit amendment to the Internal Revenue Code that established a tax credit for existing marginal wells. The intent behind the tax credit was to serve as a safety net for marginal wells during periods of low pricing. The tax credit is particularly beneficial to small well producers, who typically produce limited barrels a day. The marginal well credit is only available if commodity prices are below a certain threshold. Since its enactment, the marginal well tax credit has not been available, as prices have remained above the commodity threshold. As noted below, however, this tax credit may become available for qualified natural gas production relative to the 2016 tax year.

The marginal well tax credit provides a \$3-per-barrel credit for the production of crude oil and \$0.50-per-1,000-cubic-feet (Mcf) credit for the production of qualified natural gas.<sup>1</sup> The credit is available for domestic production from a "qualified marginal well."<sup>2</sup> A qualified marginal well generally refers to a domestic oil well that produces not more than 15 barrel of oil equivalents per day, wells that produce heavy oil, or wells with average production of not more than 25 barrel of oil equivalents a day of oil and produces not less than 95% water.<sup>3</sup>

Thus, qualified marginal gas wells generally include those producing not more than 90 Mcf a day (one barrel of oil is equivalent to six Mcf).<sup>4</sup> The maximum amount of production on which a credit may be claimed is 1,095 barrels or barrel-of-oil equivalent per year, per well.<sup>5</sup> There is no limitation on the number of wells on which a taxpayer can claim the credit. There is also a limitation for wells not capable of production during each day of a taxable year.<sup>6</sup>

To claim a marginal well credit, a taxpayer must own an operating interest in the well.<sup>7</sup> To the extent the well has more than one owner, the credit amount is allocated in proportion to the owner's revenue interests in comparison to the interests of all the operating interest owners.<sup>8</sup>

A key component of the marginal well credit is that it has a special carryback provision where unused credits may be carried back for five years.<sup>9</sup> The credit also may be carried forward for 20 years.<sup>10</sup>

For marginal oil production, the credit becomes unavailable if the reference price of oil exceeds \$18.00, with the threshold adjusted for inflation.<sup>11</sup> The term "reference price" is defined in I.R.C. Sec. 45K(d)(2)(C) as "the Secretary's estimate of the annual average wellhead price per barrel for all domestic crude oil the price of which is not subject to regulation." The 2015 reference price for oil was \$44.39, thereby exceeding the \$18.00 threshold, adjusted for inflation. As such a marginal well tax credit for marginal oil production cannot be claimed for the 2016 tax year.<sup>12</sup>

It appears that the federal marginal well tax credit for natural gas may be available for the first time for the 2016 tax year. For natural gas production, the credit becomes unavailable if the reference price of natural gas exceeds \$2.00 (per 1,000 cubic feet).<sup>13</sup> Since the inception of the tax credit in 2004, the IRS has never published a reference price for natural gas, nor has it published the inflation adjustment factor to be used in computing the marginal well tax credit. Due to the low price of natural gas in 2015, however, it is anticipated that the tax credit may be available to natural gas producers for the first time relative to the 2016 tax year.<sup>14</sup> During a recent American Bar Association Section of Taxation Meeting held in Orlando, Florida, on January 20, 2017, representatives from the Treasury and I.R.S. acknowledged that the tax credit may potentially be available in 2016 and that a reference price is expected to be published in early 2017.<sup>15</sup>

**Federal enhanced oil recovery credit:** Similar to the federal marginal well tax credit, the federal enhanced oil recovery credit is dependent upon commodity pricing, although the applicable thresholds for the two tax credits differ. A taxpayer is eligible for the federal enhanced oil recovery credit if the reference price of domestic crude oil does not exceed \$28.00, adjusted for inflation.<sup>16</sup> The enhanced oil recovery credit will be available for the 2016 tax year given the price of oil. The applicable reference price, \$44.39, does not exceed \$46.10, the product of \$28.00 multiplied by the inflation adjustment factor (1.6464) for 2016. As confirmed by the I.R.S. in Notice 2016-44 issued on July 18, 2016, the enhanced oil recovery credit will be available to taxpayers for the 2016 tax year, which is the first time the credit has been available in nearly 10 years.<sup>17</sup>

The enhanced oil recovery credit is available for qualified enhanced oil recovery projects. These projects are identified by the utilization of a tertiary recovery technique which increases the amount of crude oil extracted from an oil field.<sup>18</sup> These qualified tertiary methods include recovery methods by steam, gas flood, chemical flood, and mobility control.<sup>19</sup> However, utilization of one of these methods alone does not qualify a project for the credit; the credit requires more than an insignificant increase in the amount of crude oil that is ultimately recovered.<sup>20</sup>

Additional requirements of qualified enhanced oil recovery project include that the project must be domestically located, the initial implementation must have commenced after December 31, 1990, and the project must be certified pursuant to Regulation Section 1.43-3.<sup>21</sup>

Taxpayers who meet these requirements are entitled to a credit equal to 15% of the qualified enhanced oil recovery costs incurred in a tax year. Qualified costs include the following designated expenses:

- amounts paid for depreciable tangible property,
- intangible drilling and development expenses,
- tertiary injectant expenses, and
- construction costs for certain Alaskan natural gas treatment facilities.<sup>22</sup>

To the extent a credit is allowed for qualified enhanced oil recovery costs, taxpayers must reduce otherwise allowable deductions that are associated with these costs.<sup>23</sup> Additionally, taxpayers must reduce the basis of property by the amount of the credit where the basis would otherwise be increased by the qualified enhanced oil recovery costs.<sup>24</sup> The credit may be carried back one year or forward 20 years,<sup>25</sup> and in the event the carryforward period has expired, any unused credit is fully deductible.<sup>26</sup>

## State tax incentives

In addition to federal tax benefits, various states offer tax incentives, exemptions and exclusions for the oil and gas industry to maintain and encourage production and incentivize certain recovery activities, particularly in a low oil and gas price environment. This article seeks to highlight some of these tax incentives, focusing on some of the states with significant oil and gas exploration and recovery activity.

**Texas margin tax exclusion & severance tax incentives:** The Texas franchise tax (commonly referred to as the margin tax) is a privilege tax imposed on each taxable entity formed or organized in Texas or doing business in Texas and computed based on total revenue minus statutory exclusions. Oil and gas taxpayers subject to the margin tax may be entitled to an exclusion of all revenue earned from marginal

wells. To qualify for the exclusion, two requirements must be met: (1) the commodity price must meet the statutory threshold for any given month and (2) the well must be a qualifying well for the same month. When these requirements are met, taxpayers are able to exclude all revenue earned from the respective marginal well during the period it qualifies.

For gas wells, the Texas Comptroller must certify the closing price of gas of any given month is below \$5 per MMBtu. Secondly, the well must qualify as a marginal well. A gas well is marginal in any given month if it produces an average of 250 Mcf/day or less over the previous 90 days. Once a gas well qualifies, the production tends to remain qualified for the remainder of the year and into subsequent years.

For oil wells, the same concepts apply except the price and production amounts differ. The Comptroller must certify the price of oil of any given month is below \$40 per barrel and the oil well must average 10 barrels per day or less over the previous 90 days.

The Comptroller certifies and publishes the average closing price of oil and gas on a monthly basis in the Texas Register. The average monthly price of gas has been under \$5 for several years, so gas producers may have been able to avail themselves of the exclusion if they meet the other requirements.<sup>27</sup>

In addition to the margin tax exclusion, oil and gas taxpayers may be eligible for severance tax relief for marginal wells. Texas provides severance tax relief to producers of marginal oil and gas wells when oil and gas prices fall below certain low levels. This tax incentive became effective on September 1, 2005, and was made permanent through a legislative amendment in 2007.<sup>28</sup>

There are three levels of tax credits that can be used to offset the Texas severance tax. The tax credits are available for gas and oil production from qualified, low-producing gas wells and qualified, low-producing oil leases for any given month, depending on the Comptroller's average taxable oil and gas prices adjusted to 2005 dollars, based on applicable price indices of the previous three months. The three tax credits range from a 25%, 50%, or 100% credit to be applied against the severance tax. A qualifying, low-producing oil lease is defined as a lease that averages, over a 90-day period, less than 15 barrels per day per well or 5% recoverable oil per barrel of produced water per well.

The Comptroller's Office must certify and publish in the Texas Register, each month, the average taxable prices of oil and gas, adjusted to 2005 dollars, using applicable price indices during the previous three months. A taxpayer must apply to the Comptroller's Office for tax credits within the statutory time limit and the tax credits would only apply to crude oil and gas produced on or after September 1, 2005.<sup>29</sup>

**California enhanced oil recovery credit:** Similar to the federal enhanced oil recovery tax credit available as per I.R.C. Section 43, California offers taxpayers an enhanced oil recovery credit for qualified costs attributable to an enhanced oil recovery project. For purposes of the California enhanced oil recovery credit, the project must be located in California and involve the application of one or more tertiary recovery methods reasonably expected to result in a significant increase in the amount of crude oil recovered.<sup>30</sup>

The California enhanced oil recovery credit is equal to 5% of the taxpayer's qualified enhanced oil recovery costs.<sup>31</sup> Qualified costs incurred by these projects include:

- amounts paid or incurred for tangible property that is an integral part of a qualified enhanced oil recovery project and for which depreciation or amortization is allowed,
- intangible drilling and development costs that are paid or incurred in connection with a qualified enhanced oil recovery project and that a taxpayer may elect to capitalize and amortize under state law, and
- tertiary injectant expenses paid or incurred with respect to a qualified enhanced oil recovery project.<sup>32</sup>

The California enhanced oil recovery credit may be reduced or phased-out depending upon the reference price for domestic crude oil as considered for purposes of the federal enhanced oil recovery credit. Where the average price of uncontrolled domestic oil exceeds the threshold of \$28 per barrel, price adjusted for inflation, the California enhanced oil recovery credit becomes phased out and is unavailable to taxpayers. For the 2016 tax year, the average price of uncontrolled domestic oil did not exceed the adjusted threshold. The California enhanced oil recovery credit is available to taxpayers for the 2016 tax year after being unavailable for many tax years.<sup>33</sup>

Taxpayers should note the differences between the California and federal enhanced oil recovery credits:

- the California credit is only 5% of eligible costs as opposed to 15% at the federal level,
- the California credit is only applicable to projects located in California, and
- the California credit is not available to (1) retailers of oil and natural gas that sell to the Department of Defense and (2) certain refiners of crude oil.

Taxpayers seeking to claim the California enhanced oil recovery credit should be aware of its interaction with its federal counterpart. Since the California enhanced oil recovery credit is equal to one-third of the federal enhanced oil recovery credit as calculated in accordance with I.R.C. Section 43, a taxpayer that

does not claim the federal credit will not be eligible to claim the California tax credit. This decision is binding and irrevocable for state tax purposes.<sup>34</sup>

**Oklahoma gross production tax exemption:** Oklahoma offers its own versions of oil and gas incentives for "incremental production" resulting from enhanced recovery projects. Any incremental production attributable to a secondary enhanced recovery project beginning on or after July 1, 2000, and before July 1, 2020, will be exempt from the Oklahoma oil and gas gross production tax.<sup>35</sup> This exemption may not exceed five years from the project start date. In the event the project is terminated before this five-year period expires, the exemption will also terminate.<sup>36</sup>

The term "incremental production" refers to the amount of crude oil or other liquid hydrocarbon that is produced during an enhanced recovery project and that is in excess of the "base production amount." The "base production amount" is determined by taking the average monthly amount of production for the 12-month period immediately preceding the project start date, less the monthly rate of production decline for the project for each month beginning 180 days prior to the project start date.<sup>37</sup>

Incremental production from qualified tertiary enhanced recovery projects is exempt from the gross production tax from the project start date until the project payback is achieved; however, the exemption may not exceed a period of ten years.<sup>38</sup> Where there is a new secondary or tertiary enhanced recovery project that has been approved by the Oklahoma Corporation Commission before July 1, 2020, such approval will qualify the project for the exemption.<sup>39</sup>

The exemption is not available to enhanced recovery projects that utilize fresh water as the primary injectant, with the exception of steam injectants.<sup>40</sup> Additionally, a taxpayer may not claim the incremental production exemption in conjunction with other oil and gas credits, with the exception of the exemption from the ad valorem tax.<sup>41</sup>

Oklahoma also provides an exemption for 28 months from the date of first sale after project completion, where there is incremental production attributable to a production enhancement project.<sup>42</sup> The exemption becomes unavailable when the "average annual index price" of Oklahoma oil exceeds a threshold price, set at \$30 per barrel of oil or \$5-per-1,000-cubic-feet (Mcf), adjusted for inflation. The inflation adjustment is based on the federal Department of Labor's published Consumer Price Index—All Urban Consumers (CPI-U).<sup>43</sup>

**North Dakota oil extraction tax rate reductions & incentives:** The North Dakota Legislature has implemented various incentive mechanisms to encourage oil production by reducing the extraction tax



rate when crude prices are low. Effective for production periods starting January 1, 2016, the oil extraction tax rate was reduced from 6.5% to 5% as part of a comprehensive overhaul of the oil tax structure. Furthermore, under the new legislation, the oil extraction tax rate will fluctuate between 5% and 6% whenever the "average price" of a barrel of crude oil is above or below a trigger price of \$90/bbl for three consecutive months. The trigger price of \$90/bbl is subject to an annual adjustment based on changes in the producer price index for industrial commodities.<sup>44</sup>

North Dakota also offers taxpayers incentives for various enhanced recovery projects, which are either exemptions or rates reductions applicable to the oil extraction tax. Beginning with January 2016 production periods, incentives include exemptions for certain designated stripper wells, incremental oil exemptions for qualifying enhanced oil recovery units (RI), and a 2% rate on qualifying NonBakken/Three Forks new wells (RN).<sup>45</sup>

**Louisiana severance tax rate reductions & incentives:** Louisiana offers a host of severance tax incentives to the oil and gas industry. While the standard severance tax rate in Louisiana is 12.5% on oil production, and has been so since 1974, Louisiana law provides certain tax rate reductions depending upon the classification of the well being drilled.<sup>46</sup> Below is an overview of some of these severance tax rate reductions.

Where oil is produced from a well that is deemed "incapable" of producing an average of more than 25 barrels of oil per day during the taxable month, which also produces at least 50% salt water per day, Louisiana offers a reduced severance tax rate of 6.25%.<sup>47</sup> Additionally, oil that is drilled from a stripper well will be taxed at a rate of 3.125%. A stripper well is one that is incapable of producing an average of more than 10 barrels of oil per day during the entire taxable month.<sup>48</sup> A reduced rate of 3.125% is also provided for reclaimed oil on the value received for the first purchase. This is oil that has been reclaimed by class one salvage crude reclamation facilities which are permitted by the Office of Conservation.

Louisiana's standard severance tax rate on gas production for the period beginning on July 1, 2016, and ending on June 30, 2017, is 9.8 cents per MCF.<sup>49</sup> The state also offers reduced rates for gas, depending upon the classification of the well. For gas being produced from oil wells deemed to be "incapable," as defined above, a reduced rate of 3 cents per MCF is available to taxpayers.<sup>50</sup> Where the gas is being produced from incapable gas wells, a rate of 1.3 cents per MCF is offered by Louisiana. An incapable gas well is one that produces an average of 250,000 cubic feet of gas per day, and to qualify for the rate, the gas well must be incapable of producing 250,000 cubic feet of gas per day during the entire taxable month.

Louisiana also offers taxpayers an exemption from the severance tax on oil produced from stripper wells where the average posted price for a 30-day period is less than \$20 per barrel.<sup>51</sup> Additionally, Louisiana provides a "produced water injection incentive" aimed at reducing the discharge of produced water in the oil and gas industry. Producers of oil and gas are allowed a severance tax savings if they inject produced water into an oil and gas reservoir, from the same reservoir and field, for the purpose of increasing the recovery of hydrocarbons. The severance tax on a barrel of oil or gas incrementally produced as a result of using this method is reduced by 20%.<sup>52</sup>

**New Mexico severance tax exemptions & incentives:** New Mexico imposes a severance tax on natural gas, carbon dioxide, oil and liquid hydrocarbons removed from natural gas at or near a wellhead.<sup>53</sup> Oil and gas taxpayers may reduce their severance tax with various exemptions and tax incentives. New Mexico offers taxpayers a pricing-based, 10-year exemption for natural gas, oil, or other liquid hydrocarbon resources removed from wells within a production restoration project. The exemption is only available if the annual average price of West Texas Intermediate Crude Oil is less than a specified price per barrel.<sup>54</sup>

New Mexico also offers oil and gas taxpayers incentives in the form of special reduced severance tax rates for qualified enhanced oil recovery projects and well workover projects. Both rate reductions are dependent upon the annual average price of West Texas Intermediate Crude Oil being less than a specified price per barrel. Finally, New Mexico offers taxpayers reduced rates for gas and oil extracted from stripper wells or near a wellhead within stripper well property if the average annual taxable value of the natural gas or oil is less than, equal to, or greater than a specified price per thousand cubic feet or per specified price per barrel, respectively.<sup>55</sup>

## Conclusion

Although oil and gas prices have trended downward in recent years, oil and gas producers may be able to avail themselves of tax relief in the form of tax incentives, exemptions and exclusions on both the federal and state level. This is particularly relevant for the 2016 tax year as certain federal and state tax credits may be available for the first time in many years.

<sup>1</sup> I.R.C. § 45I(b)(1). Please note tax credit amounts are then adjusted for inflation as specified by the statutory language and legislative history.

<sup>2</sup> *Id.*

<sup>3</sup> I.R.C. § 45I(c)(3)(A).

<sup>4</sup> I.R.C. § 613A(c)(6)(E).

<sup>5</sup> I.R.C. § 45I(c)(2)(A).

<sup>6</sup> I.R.C. § 45I(c)(2)(B).

<sup>7</sup> I.R.C. § 45I(d)(2).

<sup>8</sup> I.R.C. § 45I(d)(1).

<sup>9</sup> I.R.C. § 39(a)(3).

<sup>10</sup> *Id.*

<sup>11</sup> I.R.C. § 45I(b)(2)(A).

<sup>12</sup> IRS Notice 2016-43, I.R.B. 2016-29.

<sup>13</sup> I.R.C. § 45I(b)(2)(A).

<sup>14</sup> See Ari Natter, *New Tax Credits Expected for Oil, Gas Producers*, Bloomberg BNA Daily Tax Report (May 6, 2016).

<sup>15</sup> *Id.* See also Marie Sapirie, *More Clarification Provided on 'Begin Construction' Requirement*, 154 Tax Notes 568 (Jan. 30, 2017).

<sup>16</sup> I.R.C. § 43(b)(1).

<sup>17</sup> See IRS Notice 2016-44, I.R.B. 2016-29.

<sup>18</sup> I.R.C. § 43(c)(2)(A)(i).

<sup>19</sup> Treas. Reg. § 1.43-2(e)(2).

<sup>20</sup> Treas. Reg. § 1.43-2(b).

<sup>21</sup> Treas. Reg. § 1.43-2(a).

<sup>22</sup> I.R.C. § 43(c)(1).

<sup>23</sup> I.R.C. § 43(d)(1).

<sup>24</sup> I.R.C. § 43(d)(2).

<sup>25</sup> Treas. Reg. § 1.43-1(a)(1).

<sup>26</sup> I.R.C. § 196.

<sup>27</sup> See gas prices as published by U.S. Energy Information Administration (EIA).

<sup>28</sup> Act of June 6, 2007, 80th Leg., R.S., ch. 911, 2007 Tex. Gen. Laws 2982; Tex. Tax Code Ann. § 202.058.

<sup>29</sup> *Id.*

<sup>30</sup> Cal. Rev. & Tax. Code § 23604. See also Instructions, Form FTB 3546, Enhanced Oil Recovery Credit, for acceptable tertiary recovery methods. These methods include: miscible fluid displacement, steam drive injection, micro emulsion flooding, in situ combustion, polymer-augmented water flooding, cyclic-steam injection, alkaline or caustic flooding, carbonated water flooding, immiscible nonhydrocarbon gas displacement, and any other method approved by the Secretary of the Treasury.

<sup>31</sup> Cal. Rev. & Tax. Code § 23604.

<sup>32</sup> *Id.*

<sup>33</sup> See IRS Notice 2016-44, I.R.B. 2016-29. Please note that the California Franchise Tax Board has acknowledged that the current 2016 Form 3546 and Instructions are incorrect. Taxpayers have been instructed to enter the 2016 credit amount on Line 5 of Form 3546.

<sup>34</sup> Cal. Rev. & Tax. Code § 23604; see also I.R.C. § 43(e).

<sup>35</sup> Okla. Stat. tit. 68, § 1001(D)(1).

<sup>36</sup> *Id.*

<sup>37</sup> Okla. Stat. tit. 68, § 1001(D)(4)(a).

<sup>38</sup> Okla. Stat. tit. 68, § 1001(D)(2); Okla. Admin. Code § 710:45-9-32.1(d).

<sup>39</sup> Okla. Stat. tit. 68, § 1001(D)(6).

<sup>40</sup> Okla. Stat. tit. 68, § 1001(D)(3).

<sup>41</sup> Okla. Stat. tit. 68, § 1001(U). These include an exemption for horizontal wells, oil and gas from inactive wells, incremental production resulting from certain enhanced recovery projects, oil and gas from deep spudded wells, or oil and gas from newly discovered wells. Please note that many of these exemptions may not be claimed if the tolling date begins after July 1, 2015.

<sup>42</sup> Okla. Stat. tit. 68, § 1001(G)(1); Okla. Admin. Code § 710:45-9-40.

<sup>43</sup> Okla. Stat. tit. 68, § 1001(K)(1)(a). The average index price is calculated by multiplying the West Texas Intermediate Crude closing price by the index price ratio.

<sup>44</sup> N.D. Cent. Code § 57-51.1-02. See also Letter from the State of North Dakota (Jan. 22, 2016).

<sup>45</sup> N.D. Cent. Code § 57-51.1-03.3.

<sup>46</sup> La. Rev. Stat. Ann. § 47:633(7)(b).

<sup>47</sup> *Id.*

<sup>48</sup> La. Rev. Stat. Ann. § 47:633(7)(c).

<sup>49</sup> La. Rev. Stat. Ann. § 47:633(9)(a).

<sup>50</sup> La. Rev. Stat. Ann. § 47:633(9)(b).

<sup>51</sup> La. Rev. Stat. Ann. § 47:635.

<sup>52</sup> La. Rev. Stat. Ann. § 47:633.5(C).

<sup>53</sup> N.M. Stat. Ann. § 7-29-4.A.

<sup>54</sup> N.M. Code R. § 19.15.6.9.

<sup>55</sup> N.M. Stat. Ann. § 7-29-4.A.