US tax reform

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What energy service and supply companies doing business in the US need to know

On December 22, 2017, President Trump signed into law H.R. 1, the United States (US) tax reform bill commonly referred to as the Tax Cuts and Jobs Act (the Act). The Act will result in the most sweeping changes to the tax code since 1986. A new road lies before us—implementation of the new law—and it's likely to be a long and perhaps bumpy one.

Below are our initial impressions of proposals that are considered to be of greatest importance for the energy services industry and how they may affect your business.

Corporate tax rate reduction

This provision would reduce tax rates in exchange for the elimination of certain tax benefits. For companies that currently have taxable income, which has not been the case for most in recent years due to persistently low commodity prices, lower tax rates could be favorable.

The new law would eliminate the progressive corporate income tax rate structure, currently imposing a maximum US corporate income tax rate of 35 percent, and would replace it with a flat tax rate of 21 percent on a permanent basis. The new rates would be effective for tax years beginning after December 31, 2017, however a blended rate applies for fiscal year companies, as the rate is essentially effective January 1, 2018 for all corporations.

Limitation on the deduction of net business interest expense

The new limitation on interest expense could have a negative impact on highly leveraged companies and, as a result, transition of existing debt may have to be addressed.

The new law amends section 163(j) (the earning stripping rules) to disallow a deduction for net business interest expense of any taxpayer in excess of 30 percent of a business's adjusted taxable income. Adjusted taxable income generally would be a business's EBIDTA before January 1, 2022. Of note, the new limitation does not apply to certain small businesses. This exception to the limitation applies to taxpayers with average annual gross receipts for the three-taxable-year period ending with the prior tax year that do not exceed $25 million. Any business interest disallowed generally would be carried forward indefinitely.

The provision applies to *all* businesses, regardless of form, and the limitation applies to *all* business interests (versus only interest accrued and paid to related party that is not subject to US taxation under the old tax system).

The new provision does not address what happens to a corporation's existing disallowed interest expense for which a deduction was not claimed because of existing section 163(j). Thus, it is unclear if Congress intends that a corporation may treat that disallowed interest expense as business interest paid or accrued in a year after the effective date of the provision.

Cost recovery—Increase expensing

This provision could have an important effect on M&A transactions. It increases the incentive for buyers to structure taxable acquisitions as actual or deemed (e.g., pursuant to section 338) asset purchases, rather than stock acquisitions, by enabling the purchasing entity in an asset acquisition to immediately deduct a significant component of the purchase price, and potentially to generate net operating losses in the year of acquisition that could be carried forward (subject, in general, to an 80 percent of taxable income limitation) to shield future income.

Generally, the bonus depreciation percentage is increased from 50 percent to 100 percent for property acquired and placed in service after September 27, 2017, and before 2023. It also provides a phase down of the bonus depreciation percentage for property placed in services from 2023 through 2026 (80%-60%-40%-20%). "Bonus-eligible qualified property" includes *used* property acquired by purchase, so long as it is the acquiring corporation's *first* use and the property is not acquired from a related party.

Repeal deduction for income attributable to domestic production activities

The deduction for domestic production activities provided under section 199, from which many energy services companies have benefited, is repealed for tax years beginning after December 31, 2017. The repeal of section 199 would offset some of the benefit of the lower tax rates for profitable companies in the oil and gas industry.

While the new law eliminates the rate reduction created by section 199, a separate provision of the legislation effects a much larger overall corporate rate reduction.

Accelerating income to or deferring deductions from the final year in which section 199 is available may provide a permanent increase in the amount of the domestic production activities deduction that is available. Yet such potential planning must be balanced against the benefits of more traditional planning (deferral of income and acceleration of deductions) in the context of tax rate reform.

For publicly listed companies—The impact on financial statements

Tax reform contains several key provisions that may have significant financial statement effects. These effects include:

- Remeasurement of deferred taxes;
- Recognition of liabilities for taxes on mandatory deemed repatriation and certain other foreign income;
- Reassessment of the valuation allowance; and
- Presentation and disclosure requirements.

For KPMG reports on the Tax Reform impact on the Accounting for Income Taxes under IFRS and US GAAP, please see:

- Tax reform: Supplement to KPMG's Handbook, Accounting for Income Taxes
- Tax reform in the United States: Q&As for IFRS preparers

Companies of all sizes need to evaluate and respond to the impact of the new law proactively and promptly as there may be significant consequences to the businesses as well as its financial reporting.

KPMG US tax team is ready to help. Please contact the following US tax professionals for more information.

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