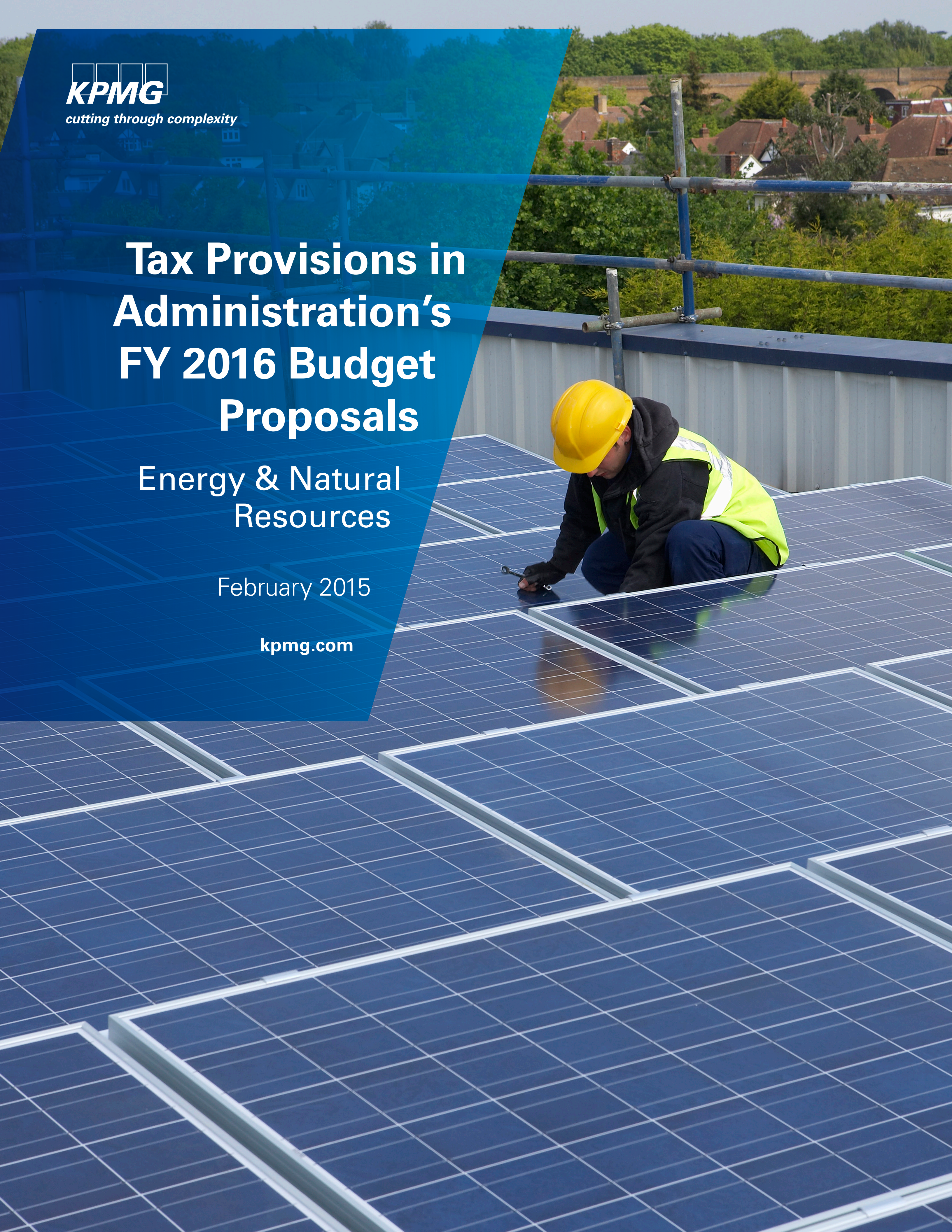

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Tax Provisions in Administration's FY 2016 Budget Proposals

Energy & Natural Resources

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HIGHLIGHTS OF TAX PROPOSALS IN THE ADMINISTRATION'S FISCAL YEAR 2016 BUDGET RELATING TO ENERGY AND NATURAL RESOURCES

KPMG has prepared a 111-page **book** that summarizes and makes observations about the revenue proposals in the Administration's FY 2016 budget. For ease of reference, we have compiled our summaries and observations relating to certain specific industries and topics in separate booklets. This booklet highlights revenue proposals relating to Energy and Natural Resources. Other booklets will address proposals relating to the following topics:

- International Tax
- General Corporate Tax
- Tax Accounting
- Business Tax Credits
- Financial Institutions & Products
- Passthrough Entities
- Practice, Procedures, & Administration
- Charitable Deductions & Exempt Organizations
- Compensation, Benefits, & Qualified Plans
- Insurance
- Real Estate
- Taxation of Individuals

Background

On February 2, 2015, President Obama transmitted to Congress the administration's recommendations to Congress for spending and taxation for the fiscal year that begins on October 1, 2015 (i.e., FY 2016).

Among many other things, the president proposed a six-year $478 billion program for transportation infrastructure, the cost of which would be offset in part by a one-time tax on the unrepatriated foreign earnings of U.S. multinational corporations. This tax would be part of a transition to a proposed fundamental change in the taxation of the future foreign earnings of U.S. corporations that would effectively eliminate deferral of tax on foreign earnings, causing them generally to be taxed on a current basis at a reduced rate.

The president also proposed a reserve for business tax reform, but not one of sufficient magnitude for significant rate reduction. The president has called for reducing the corporate income tax rate to 28%, but the budget does not provide revenue to offset the cost of such a reduction. Instead, the budget refers only to eliminating tax expenditures, such as accelerated depreciation and "reducing the tax preference for debt financed investment."

Many of the “general” business tax proposals in the FY 2016 budget are familiar, having been raised in previous budgets. These proposals include, for example:

- Reforms to the international tax system
- Repeal of natural resources production preferences
- Repeal of LIFO and LCM accounting
- Taxation of carried interests in partnerships as ordinary income
- Insurance industry reforms
- Mark-to-market of financial derivatives
- Modification of the like-kind exchange rules
- Modification of the depreciation rules for corporate aircraft
- Denial of a deduction for punitive damages
- Make permanent and reform the credit for research and experimentation
- Make permanent the Subpart F exception for active financing income
- Make permanent look-through treatment of payments between related CFCs

The president also re-proposed a tax on the liabilities of financial institutions with assets in excess of $50 billion. The rate would be reduced relative to the prior proposal from 17 basis points to 7 basis points, but the base of the tax would be different and the application of the tax would be significantly broadened to include insurance companies, savings and loan holding companies, exchanges, asset managers, broker-dealers, specialty finance corporations, and financial captives. These changes have roughly doubled the revenue raised relative to the proposal in the FY 2015 budget.

The budget also includes a host of proposed changes to the individual income tax system. These include increasing the highest tax on capital gains from 23.8% (including the 3.8% net investment income tax) to 28%. In addition, a transfer of appreciated property would generally be treated as a sale of the property, subject to various exceptions and exclusions. For example, relief would be provided to lessen the immediate impact of the proposed change on the transfers of small businesses.

Energy Proposals

With a few exceptions, the budget repeats a number of energy proposals from prior years. One new addition for FY 2016 is a proposal to disqualify fossil fuel related income for publicly traded partnerships. That income disqualification would lead fossil fuels PTPs to generally be taxed at the entity level.

The FY 2016 proposals also include an important modification for renewable energy projects. Prior budgets would have allowed the solar investment tax credit to expire and force solar projects into the production tax credit. This year’s budget proposes to make the solar investment tax credit permanent and allows taxpayers to choose between the investment tax credit and the production tax credit.

Energy and Natural Resources Tax Proposals

This booklet addresses the following budget proposals:

Fossil Fuel Provisions

Eliminate Fossil Fuel Tax Preferences

The administration's FY 2016 proposal would repeal several preferences currently available to the oil and gas sector because "[t]he President agreed at the G-20 Summit in Pittsburgh to phase out fossil fuels":

Repeal fossil fuel qualified income for publicly traded partnerships

Section 7704 provides that certain partnerships may be publicly traded entities while maintaining passthrough status. These entities are thus exempted from the corporate tax.

To qualify for this exemption, 90% or more of the gross income of the partnership must be qualifying income. Qualifying income generally includes income derived from (among other sources) the exploration, development, mining or production, processing, refining, transportation (including pipelines), or marketing (other than at retail to an end user) of certain fossil fuels.

The administration's FY 2016 budget introduces a new proposal that would repeal the exemption from corporate tax for publicly traded partnerships (PTPs) that derive qualifying income from activities relating to fossil fuels. The proposal would be effective after December 31, 2020.

KPMG observation

When the PTP provisions were originally enacted, fossil fuels were included in the qualified income exception to the treatment of PTPs as C corporations because that industry had traditionally used partnership entities. Fossil fuel related PTPs are approximately 85% of all qualified PTPs currently treated as partnerships.

Notably, the *Tax Reform Act of 2014* proposed by the former Chairman of the House Ways and Means Committee, Dave Camp, in the last congress also included narrowing the scope of the PTP rules. However, the Camp tax reform bill would have required financial services PTPs to be classified as corporations, but would have allowed fossil fuel PTPs to maintain passthrough status.

Elsewhere, the FY 2016 Budget contains a proposal to limit the amount of capital gain deferred under the like-kind exchange rules on an exchange of real property to $1 million per taxpayer per tax year. While not specifically a fossil fuel provision, this limitation on like-kind exchanges of real property could have a substantial negative impact on some natural resource conservation measures, often required by local law. Natural resource property is defined by section 614. Specifically, section 614(b)(3) treats properties participating in a unitization or pooling agreement as a single property. Unitizations and poolings are conservation techniques that prevent producers who own tracts of land over a larger pool of minerals from rushing to produce reserves (law of capture) from that pool of minerals and often reducing the total recovery of reserves.

For federal income tax purposes the term "unitization or pooling agreement" means an agreement under which two or more persons owning operating mineral interests agree to have the interests operated on a unified basis, and the owners also agree to share in production on a stipulated percentage or fractional basis regardless of which interest or interests the oil or gas is produced from. In addition, when one person owns all of the operating mineral interests in several leases, an agreement with its several royalty owners to determine the royalties payable to each on a stipulated percentage basis (regardless of which lease(s) oil or gas is produced) is also considered to be a unitization or pooling agreement. No formal cross-conveyance of properties is necessary.

Rev. Rul. 68-186, 1968-1 C.B. 354 noted that:

> The position that a unitization effects an exchange was confirmed by the amendment to section 614 of the Internal Revenue Code of 1954 made by the Revenue Act of 1964. Section 614(b)(3) of the Code; H. Rept. No. 749, C.B. 1964-1 (Part 2), 125, at 216; S. Rept. No. 830, C.B. 1964-1 (Part 2), 505, at 622. The exchange of working interests qualifies, as does the exchange of equipment, under section 1031 of the Code as property held for productive use in a trade or business or for investment which is exchanged solely for property of a like kind to be held for use in a trade or business or for investment.

On some federal offshore properties, the producers cannot enter a unit without first drilling a producing well. This causes a series of unit enlargements (e.g., up to 12 enlargements of the same unit), each of which is treated as a section 1031 exchange. Treating unitizations and poolings (including communalizations formed pursuant to 30 U.S.C. § 226(m); 43 C.F.R. § 3105.2-2) as taxable events would run counter to their conservation nature causing substantial unwarranted tax bills.

Modify like-kind exchange rules for real property and collectibles

Current law provides that no gain or loss is recognized when business or investment property is exchanged for "like-kind" business or investment property.

According to the the Treasury Department's general explanation of the tax proposals of the budget—the so-called "**Green Book**"—the administration believes there is little justification for allowing deferral of the capital gain on the exchange of real property (as opposed to personal property used in a trade or business, such as machinery and equipment). Among other things, the Green Book indicates that the ability to exchange unimproved real estate for improved real estate encourages "permanent deferral" by allowing taxpayers to continue a cycle of tax deferred exchanges, with potentially no tax ever being imposed on increased value of the disposed properties.

As was the case for the previous fiscal year's budget proposal, the administration's FY 2016 proposal would limit the amount of capital gain deferred under these rules from the exchange of real property to $1 million (indexed for inflation) per taxpayer per tax year. It would not affect the treatment of exchanges of personal property. Treasury would be granted regulatory authority necessary to implement the provision, including rules for aggregating multiple properties exchanged by related parties.

The proposal would be effective for like-kind exchanges completed after December 31, 2015.

KPMG observation

The Camp tax reform bill proposed repealing section 1031 entirely. Thus, there appears to be an increased focus on section 1031, both by the administration and by key lawmakers.

Reduce excise taxes on liquefied natural gas (LNG) to bring into parity with diesel

Beginning after 2015, the administration's FY 2016 proposal would lower the $0.243 per gallon alternative fuel excise tax on LNG to $0.141 per gallon so that the tax on LNG is at parity with diesel fuel on an energy-content adjusted basis.

Currently, an alternative fuel excise tax of $0.243 cents per gallon is imposed on LNG delivered into the fuel supply tank of certain motor vehicles.

The tax would be dedicated to the Highway Trust Fund.

Modify tax rules for dual capacity taxpayers

The administration's FY 2016 proposal to modify the tax rules for dual-capacity taxpayers is substantially similar to the provision included in the administration's FY 2015 budget, except it generally would be effective for tax years beginning after December 31, 2015.

KPMG observation

The administration's FY 2016 budget also includes a new proposal that would supplement the existing subpart F regime with a new per-country minimum tax on foreign earnings of U.S. corporations and controlled foreign corporations (CFCs). It is not clear how the dual capacity taxpayer proposal interacts with the minimum tax proposal. Note, however, that the revenue estimate for the dual capacity taxpayer proposal is smaller than it was in the FY 2015 budget, suggesting that there could be an interaction effect between the minimum tax proposal and the dual capacity taxpayer proposal.

Other

A number of fossil-fuel related proposals have been carried over from previous budgets and appear to be unchanged (except for effective dates), including:

- Repeal the section 43 enhanced oil recovery credit
- Repeal the section 45I credit for qualified crude oil and natural gas production from a marginal well
- Repeal the section 263(c) expensing of intangible drilling costs
- Repeal the section 193 deduction for tertiary injectants
- Repeal the section 469(c)(3) exception to passive loss limitation for working interests in oil and natural gas properties
- Repeal percentage depletion for oil and natural gas wells
- Repeal the section 199 domestic manufacturing deduction for oil and natural gas and coal and other hard mineral fossil fuels
- Increase geological and geophysical amortization period for independent producers to seven years under section 167(h)
- Repeal expensing of mining exploration and development costs
- Repeal percentage depletion for hard mineral fossil fuels
- Repeal capital gains treatment for coal and lignite royalties

The repeal of these additional items would generally be effective after December 31, 2015.

Alternative Energy and Energy Efficiency

Provide a carbon dioxide investment and sequestration tax credit

Current law allows a tax credit to taxpayers that sequester carbon dioxide (CO_2) emissions. The credit is equal to $20 per metric ton if the CO_2 is properly stored and $10 per ton if it is used as a tertiary injectant in an enhanced oil or natural gas recovery project. The credit is available through the tax year in which an aggregate of 75 million tons has been sequestered. The credit is indexed for inflation.

To facilitate technological advances that will assist in controlling future greenhouse gas emissions, the administration's FY 2016 budget proposes a new refundable investment tax credit for up to 30% of the installed cost of transportation and storage infrastructure to be used in CO_2 sequestration at certain electric generating units. Apparently, the credit would be available to generating units that capture more than 75% of their CO_2 emissions. Both new and retrofitted units would be eligible; a retrofitted unit would need to have a capacity greater than 250 megawatts and capture and store more than 1 million metric tons of CO_2 a year.

The investment tax credit would be allocated to applicants, based on numerous specified factors, for all or part of their qualified investment. A total of $2 billion of credits would be available. At least 70% of the credits would be required to flow to projects fueled by greater than 75% coal. Applications would be due 18 months after the date of enactment, and the allocations would occur after that.

The proposal would also provide a new, refundable sequestration credit, $10 per metric ton of CO_2 if permanently sequestered and beneficially used, such as in an enhanced oil recovery operation, and $50 per metric ton if permanently sequestered and not beneficially reused. The credit would be allowed for a maximum of 20 years of production. The rate would be indexed for inflation.

The proposal would be effective after the date of enactment.

Modify and permanently extend renewable electricity production tax credit and investment tax credit

The administration's FY 2016 proposal would expand existing federal income tax incentives for renewable energy projects.

Section 45 provides a production tax credit (PTC) for the production of electricity from wind energy at facilities that began construction prior to 2015 and also provides a PTC for the production of electricity from biomass, geothermal, trash combustion, hydropower, landfill gas, and marine and hydrokinetic facilities if construction begins on the facility prior to 2015. The PTC is available for a 10-year period beginning with the date the facility is originally placed in service. In order to claim the PTC, the electricity produced by the facility must be sold to third parties.

In addition, section 48 provides an investment tax credit (ITC) for 10% or 30% of energy credit property placed in service prior to 2017. Energy-credit property includes solar, geothermal, fuel cell, microturbine, combined heat and power, and small wind property. A 10% ITC is available for solar property placed in service after 2016. There is no expiration date for a 10% ITC for geothermal property (non-heat pump). In addition, PTC-qualifying facilities may elect to claim the ITC instead of the PTC, but only for PTC-qualifying facilities that began construction by their PTC mandated deadline (i.e., construction must begin before 2015).

The administration's FY 2016 proposal would extend the current law PTC for facilities on which construction begins before 2016. For facilities on which construction begins after December 31, 2015, the proposal would permanently extend the PTC and make it refundable. The proposal would also eliminate the third-party sales requirement, making the PTC available in cases where the electricity is consumed directly by the producer, to the extent that production can be independently verified.

A PTC would be allowed for residential energy efficient property installed in a dwelling unit; the current credit for energy efficient property would expire at the end of 2016.

Solar facilities that currently qualify for the ITC would be eligible for the PTC in lieu of the ITC for construction that begins after 2015.

The FY 2016 proposal would make the ITC permanent. It would also make permanent the election to use the ITC, rather than the PTC, for facilities for which production is allowed the PTC

KPMG observation

By making the PTC refundable, the proposal would lessen the need for renewable energy developers to obtain tax-equity financing. Tax-equity financing is a form of equity financing whereby a renewable energy developer seeks an outside investor that can efficiently utilize the tax attributes. In a tax-equity transaction, the credits are specially allocated to the outside investor through the use of a partnership flip transaction.

The elimination of the third-party sales requirement would make the PTC more valuable for technologies such as solar and open-loop biomass, the electricity from which is most often consumed on-site.

Previous administrative proposals would have repealed the ITC.

Provide additional tax credits for investment in qualified property used in a qualifying advanced energy manufacturing project

The administration's FY 2016 proposal would extend the qualified advanced energy property (QAEP) credit.

The QAEP credit under section 48C is a 30% investment tax credit that is available for the construction, re-equipping, or expansion of a manufacturing facility that constructs QAEP. Included in the definition of QAEP is property such as solar, wind and other renewable energy component property, electric grids, carbon dioxide capture and sequestration property, plug-in electric vehicles and component parts, etc. QAEP credits were first enacted as part of the *American Recovery and Reinvestment Act of 2009,* and $2.3 billion in QAEP credits were originally authorized. All of the credits were allocated by Treasury in two separate allocation rounds.

The administration's FY 2016 proposal would authorize an additional $2.5 billion of QAEP credits. Up to $200 million of the credits may be allocated to the construction of infrastructure that contributes to networks of refueling stations that serve alternative fuel vehicles. Under the proposal, taxpayers would be allowed to apply for a credit with respect to either all or only **a part of** the qualified investment in the project. If a taxpayer applies for a credit with respect to only a portion of its qualified investment, the taxpayer's increased cost sharing and the reduced cost to the government would be taken into account in the allocation process.

The proposal would be effective as of the date of enactment.

Extend the tax credit for cellulosic biofuels

The administration's FY 2016 proposal would extend the tax credit for cellulosic biofuels producers.

Section 40 provides a $1.01 per gallon tax credit for the production of cellulosic biofuels, however, the credit expired on December 31, 2014.

The proposal would retroactively extend the credit from January 1, 2015, through December 31, 2020. Beginning in 2021, the amount of the credit would be reduced by 20.2 cents per gallon in each subsequent year, so that the credit would expire after December 31, 2024.

Modify and permanently extend the deduction for energy-efficient commercial building property

Section 179D provides a deduction in an amount equal to the cost of "energy efficient commercial building property" placed in service during the tax year. The section 179D deduction expired on December 31, 2014.

The proposal would extend the current law for property placed in service before January 1, 2016, and update it to apply Standard 90.1-2004.

For facilities placed in service after December 31, 2015, the proposal would permanently extend and modify the current deduction with a larger fixed deduction. The proposal would raise the current maximum deduction for energy-efficient commercial building property to $3.00 per square foot (from $1.80 per square foot). The maximum partial deduction allowed with respect to each separate building system would be increased to $1.00 per square foot (from $0.60 per square foot).

For taxpayers that simultaneously satisfy the energy savings targets for both building envelope and heating, cooling, ventilation, and hot water systems, the proposal would increase the maximum partial deduction to $2.00 per square foot (from $1.20 per square foot). Energy-savings targets would be updated every three years by the

Secretary of Treasury in consultation with the Secretary of Energy to encourage innovation by the commercial building industry.

A deduction would also be allowed, beginning in 2016, for projected energy savings from retrofitting existing commercial buildings with at least 10 years of occupancy.

A taxpayer could only take one deduction for each commercial building property.

KPMG observation

By increasing the basic deduction from $1.80 to $3.00, the proposal would substantially enhance the incentive for taxpayers.

Modify and extend the tax credit for the construction of energy-efficient new homes

The administration's FY 2016 proposal would modify and extend the section 45L credit for the construction of new energy efficient homes.

Under section 45L, the credit is $1,000 per home for homes 30% more efficient in terms of heating and cooling than a comparable dwelling constructed in accordance with certain prescribed standards. The section 45L credit is $2,000 per home for homes 50% more efficient than the standard. The credit applies to homes acquired before January 1, 2015.

For homes acquired after December 31, 2015, and before January 1, 2026, the proposal would provide a $1,000 energy efficient new home tax credit for the construction of a qualified ENERGY STAR certified new home acquired for use as a residence. In addition, a $4,000 tax credit would be provided for the construction of a qualified DOE Zero Energy Ready Home acquired for use as a residence. To provide that a new home meets ENERGY STAR or DOE Zero Energy Ready guidelines, verification by a qualified third party would be required.

Vehicles

Provide a tax credit for the production of advanced technology vehicles

The administration's FY 2016 proposal would expand the types of alternative vehicles that are eligible for a tax credit.

Section 30D provides a credit for placing in service qualified plug-in electric drive motor vehicles. The maximum credit available for qualified vehicles is $7,500 with a 200,000 vehicle per manufacturer limitation.

The administration's FY 2016 proposal would replace the credit for plug-in electric drive motor vehicles with a credit for "advanced technology vehicles." An advanced technology vehicle is a vehicle meeting the following criteria:

- The vehicle operates primarily on an alternative to petroleum;
- As of January 1, 2014, there were few vehicles in operation in the United States using the same technology as such vehicle; and
- The technology used by the vehicle exceeds the footprint-based target miles-per-gallon gasoline equivalent (MPGe) by at least 25%.

The credit would be limited to vehicles weighing no more than 14,000 pounds. Generally the credit would be the sum of $5,000 and the product of 100 and the amount by which the vehicle's miles per gallon equivalent exceeds its footprint-based target miles per gallon, but would be capped at $10,000 ($7,500 for vehicles with an MSRP above $45,000). The credit for a battery-powered vehicle would be determined under the current rules under section 30D if that computation results in a larger credit.

Under the administration's FY 2016 proposal, the credit would be available to the manufacturer of the vehicle, but the manufacturer would have the option to transfer the credit to a dealer that sells the vehicle to the end-use purchaser of the vehicle. If the credit is transferred to an end-use business purchaser, the purchaser would not be required to reduce the basis of the depreciable property by the amount of the credit.

The credit would be allowed for vehicles placed in service after 2015 and before January 1, 2023, though the credit would step down by 25% each year starting in 2020.

Provide a tax credit for medium- and heavy-duty alternative-fuel commercial vehicles

The administration's FY 2016 proposal would provide a tax credit for certain medium and heavy-duty weight vehicles that are powered by alternative fuels.

Section 30B provides credits for a taxpayer who places in service alternative motor vehicles. Currently, section 30B provides a credit for fuel-cell vehicles, and the credit is available for vehicles purchased before 2015. Section 30B also provides a credit for alternative-fuel motor vehicles; however, that credit expired in 2011.

The administration's FY 2106 proposal would allow a tax credit for dedicated alternative fuel vehicles weighing more than 14,000 pounds (i.e., trucks and buses). The administration would allow a credit of $25,000 for vehicles weighing up to 26,000 pounds and a credit of $40,000 for vehicles weighing more than 26,000 pounds.

The credit would be available to the manufacturer of the vehicle, but the manufacturer would have the option to transfer the credit to a dealer that sells the vehicle or the vehicle's end-use purchaser. If the credit is transferred to an end-use business purchaser, the purchaser would not be required to reduce the basis of the depreciable property by the amount of the credit.

The credit would be allowed for vehicles placed in service after 2015, and before 2022. For vehicles placed in service in calendar year 2021, the credit would be limited to 50% of the otherwise allowable amount.

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