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KPMG report: Oil, gas and mining provisions—House, Senate Finance Committee versions of tax reform bills

The U.S. House of Representatives passed a tax reform bill—H.R. 1, the "Tax Cuts and Jobs Act"—on November 16, 2017. The Senate Finance Committee also on November 16, 2017, approved its version of a tax reform bill. Statutory language of the Senate Finance bill was released on November 20, 2017.

The following discussion provides initial impressions of certain proposals that are considered to be of greatest importance for the oil, gas, and mining industry in the bill approved by the House and compares those provisions to similar proposals in the Senate Finance Committee's bill.

For analysis and observations of the provisions in the bills:

- Read KPMG's report [PDF 1.7 MB] providing initial analysis and observations on the Ways and Means bill.
- Read KPMG's report [PDF 1.1 MB] providing initial analysis and observations on the Senate Finance bill for tax reform.

Corporate tax rate reduction

Reduction of maximum corporate income tax rate to 20%

House bill: The House bill (section 3001) would eliminate the progressive corporate income tax rate structure, currently imposing a maximum U.S. corporate income tax rate of 35%, and would replace it with a flat tax rate of 20% (and make various corresponding changes throughout the Code). Further, the U.S. corporate income tax rate on personal service corporations would be reduced to 25%, resulting in a 10 percentage point reduction from the current rate of 35%. The new rates would be effective for tax years beginning after 2017. The House bill would also repeal the

alternative corporate tax on net capital gain (Code section 1201). The Joint Committee on Taxation (JCT) has estimated that the reduction in corporate rates will decrease revenues by $1.462 trillion over 10 years.

Senate Finance Committee bill: The Senate Finance bill would also reduce the maximum corporate income tax rate to 20%, but the change would be effective for tax years beginning after 2018. The Senate Finance bill would eliminate the special tax rate for personal services corporations.

KPMG observation

This reduction is intended to make the U.S. corporate income tax rate more competitive with the rates imposed by other countries. Consistent with the overall theme of the bill, this provision would reduce tax rates in exchange for the elimination of certain tax benefits. The proposed flat 20% corporate tax rate (beginning in 2018 in the House bill and 2019 in the Senate Finance bill) is higher than the 15% rate proposed by President Trump's tax plan. For companies that currently have taxable income, which has not been the case for most in recent years with low commodity prices, lower tax rates could be favorable.

Limitation on the deduction of net business interest expense

House bill: Section 3301 of the House bill would amend section 163(j) to disallow a deduction for net business interest expense of any taxpayer in excess of 30% of a business's adjusted taxable income.

For this purpose, adjusted taxable income generally would be a business's taxable income (and could not be less than zero) computed without regard to: (1) any item of interest, gain, deduction, or loss that is not properly allocable to a trade or business; (2) business interest or business interest income; (3) the amount of any net operating loss deduction; and (4) depreciation, amortization, and depletion. Business interest would be defined as any interest paid or accrued on indebtedness properly allocable to a trade or business.

Disallowed interest expense could be carried forward only five years.

The provision would be effective for tax years beginning after 2017. The JCT estimates the provision would increase revenues by approximately $172 billion over 10 years.

Senate Finance Committee bill: The Senate Finance bill includes a similar provision, but unlike the provision in the House bill, it would not exclude depreciation, amortization, and depletion from adjusted taxable income. In addition, the Senate Finance bill would provide an indefinite carryforward for disallowed interest expense.

KPMG observation

It is unclear how what is “properly allocable to a trade or business” would be determined. Business interest not properly allocable to the delineated businesses would be either properly allocable to some other trade or business or would presumably be treated as other types of interest and subject to existing rules for the treatment of interest (e.g., investment interest).

Cost recovery - Increase expensing

House bill: Under the House bill, the additional first-year depreciation deduction (bonus depreciation) would be increased and expanded.

According to the House bill, generally, the bonus depreciation percentage would be increased from 50% to 100% for property acquired and placed in service after September 27, 2017, and before 2023 (with an additional year for certain qualified property with a longer production period).

The proposed statutory language would expand the definition of qualified property to include used property, provided it is the taxpayer’s first use of the property. Under current law, bonus depreciation is available only for property, the original use of which begins with the taxpayer.

The definition of qualified property would be modified to exclude any property used in a trade or business of furnishing or selling electrical energy, water or sewage disposal services, gas or steam through a local distribution system, or transportation of gas or steam by pipeline if the rates for such furnishing or sale are subject to rate regulation.

Under the proposed statutory language, a provision that allowed corporate taxpayers to treat AMT credits as refundable in lieu of claiming bonus depreciation would be repealed, effective for tax years after 2017.

In the case of the taxpayer’s first tax year ending after September 27, 2017, the taxpayer could elect to apply section 168 without regard to the amendments made by the proposed statutory language. The proposed statutory language further provides that in the case of any tax year which includes any portion of the period beginning September 28, 2017, and ending on December 31, 2017, the amount of any net operating loss that may be treated as a carryback would be determined without regard to the amendments made by the proposed statutory language.

Special anti-abuse transition rules would apply to qualified property acquired by the taxpayer before September 28, 2017, and placed in service after September 27, 2017. The JCT estimates that the provision (with the December 31, 2022 sunset date) would decrease revenues by $25 billion over 10 years.

Senate Finance Committee bill: The Senate Finance bill contains similar provisions except that bonus depreciation would not be available for used property and would become effective in 2019.

Both the House and Senate Finance bills would continue to allow the higher of cost or percentage depletion for oil and gas, geothermal and other minerals under present sections 613 and 613A.

KPMG observation

If the House provision is ultimately enacted, it could have implications for M&A transactions. It would increase 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 (with annual increases for an interest component) to shield future income.

Repeal deduction for income attributable to domestic production activities

House bill: Under section 3306 of the House bill, the deduction for domestic production activities provided under section 199 would be repealed for tax years beginning after December 31, 2017.

A separate provision of the bill would extend the section 199 deduction for income attributable to qualifying activities performed in Puerto Rico for tax years before January 1, 2018 (a one-year extension).

The JCT has estimated that repealing section 199 would increase revenues by approximately $95.2 billion from 2018-2027. The one-year extension related to Puerto Rico would decrease revenues by approximately $800 million over the same 10-year period.

Senate Finance Committee bill: The Senate Finance bill includes a similar provision, but without relief provisions for Puerto Rico, and it would be effective for tax years beginning after December 31, 2018.

KPMG observation

The original intent of the section 199 deduction was to provide a targeted corporate rate reduction that would allow U.S. companies to compete against international tax systems, while also drawing international companies to the United States and its tax structure. While this proposed provision would eliminate the rate reduction created by section 199, a separate provision of the House bill proposes an overall corporate rate reduction (discussed above). While 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, 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. 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.

Repeal of corporate AMT

House bill: The House bill would repeal the corporate alternative minimum tax (AMT) effective for tax years beginning after December 31, 2017. Any AMT credit carryovers to tax years after that date generally could be utilized to the extent of the taxpayer's regular tax liability (as reduced by certain other credits). In addition, for tax years beginning in 2019, 2020, and 2021, to the extent that AMT credit carryovers exceed regular tax liability (as reduced by certain other credits), 50% of the excess AMT credit carryovers would be refundable (a proration rule would apply with respect to short tax years). Any remaining AMT credits would be refundable in 2022.

Senate Finance Committee bill: The Senate Finance bill includes a similar provision except that AMT credits would be 50% refundable in 2018, 2019, and 2020, and 100% refundable in 2021. The Senate Finance bill would also limit the net operating loss (NOL) deduction for a given year to 90% (80% for tax years beginning after 2022) of taxable income.

KPMG observation

In general: Repealing the corporate AMT would eliminate some of the complexity inherent in U.S. corporate taxation. For taxpayers with significant corporate AMT credit carryovers, the House bill's generous rules would allow the full use of the credits to reduce or eliminate regular tax liability, and to obtain tax refunds to the extent the AMT credit carryovers exceed regular tax liability.

Natural resources: The repeal of the corporate AMT also would eliminate the ability of taxpayers to use the optional 10-year write-off (five years for intangible drilling costs) contained in Code section 59(e) to minimize the disparity between certain AMT adjustments and preference items, which makes a taxpayer's regular income tax closer to the alternative minimum tax. This change would affect intangible drilling and development costs for oil, gas, and geothermal wells (integrated oil corporations would still be required to capitalize 30% of their IDC allowable as a deduction ratably over the 60-month period beginning with the month in which the costs are paid or incurred) and the deduction for certain mine exploration and development expenditures. Under the AMT regime, mines were generally limited to cost depletion. However, for regular income tax purposes, depletion on mines would remain the higher of cost or percentage depletion for the tax year. Independent oil and gas producers could still claim the higher of cost depletion or percentage depletion under section 613A. International mineral companies may seek to have the elective capitalization and amortization provisions in Code section 59(e) placed in an income tax section to avoid having a domestic loss reduce foreign source income that is covered by foreign tax credits.

Limitation on net operating losses

Both the House and Senate Finance bills would eliminate net operating loss (NOL) carryback provisions in most cases and limit NOL carry forwards to 90% of taxable income. The Senate Finance bill would decrease the NOL carry forwards to 80% of taxable income after 2022.

KPMG observation

Many natural resource extraction companies generate NOLs during cycles of low product prices and would likely be affected by the inability to carry back NOLs and receive cash refunds of previously paid income taxes.

Repeal the enhanced oil recovery credit and the credit for producing oil and gas from marginal wells

The House bill would repeal the section 43 enhanced oil recovery credit and the section 45I credit for producing oil and gas from marginal wells.

The Senate Finance bill would not repeal the section 43 or section 45I credits.

LIFO inventory method not repealed

Neither the House nor Senate Finance bills would repeal the LIFO inventory method. The repeal of LIFO as an inventory method would likely have hurt oil refiners who generally keep large volumes of feedstocks and products.

Multinational entity taxation

Both the House and Senate Finance bills would move the United States from a system of worldwide taxation with deferral to a participation exemption regime with current taxation of certain foreign income. To accomplish this, the bills would adopt several features, including:

- A 100% exemption for dividends received from 10% or greater-owned CFCs
- A minimum tax on certain income (and both bills contain exceptions for certain oil and gas income)
- A transition to the new regime through mandatory repatriation of previously untaxed “old earnings”

A 10% rate would apply to cash and cash equivalents and a 5% rate would apply to illiquid assets under the Senate Finance bill and 14% / 7% corresponding rates under the House bill.

Both bills propose additional anti-base erosion measures in the new regime. The Senate Finance bill and the House bill seek similar outcomes in this regard, yet differ in approach. The House bill has a related-party transactions excise tax with an effectively connected income alternative election. The Senate Finance bill instead applies a “Base Erosion Anti Abuse Tax” (BEAT). The BEAT would generally have the

effect of imposing an alternative tax based on the elimination of certain deductions and credits. Unlike the House bill, the Senate Finance provision generally would not target cost of goods sold attributable to related-party transactions, but would target related-party interest.

Both the House and Senate Finance bills include additional limitations on interest deductions in which a U.S. corporation is part of an international financial reporting group.

The Senate Finance bill includes several other international provisions including revised treatment of hybrids, a deduction for certain foreign derived intangible income, and rules for both inbound and outbound transfers of intangibles.

Publicly traded partnerships

Both the House and Senate Finance bills preserve the ability of qualifying businesses to be classified as publicly traded partnerships (PTP) under section 7704(c) and apply the same rules to partnerships and corporations, giving the PTP investors the benefit of any additional "tax shield" generated by the partnership.

While this may be attractive for PTPs in the first year, as with previous bonus depreciation, many PTPs may prefer to have the ability to opt out of full expensing because the benefit of the shield in subsequent years is reduced as a result of the passive loss rules of section 469.

The provisions with respect to the ability to deduct interest expense are generally the same for PTPs and corporations. Note that in the context of partnerships, the limitation is applied at the partnership level such that interest may be disallowed at the partnership level if it exceeds 30% of adjusted taxable income for the year. If it is less than 30% of adjusted taxable income, the excess capacity may be taken into account at the partner level.

The House bill would reduce the rate for individuals to 25% on certain income. In general, the new rate would apply to all net business income from passive activities and to the "capital percentage" of net business income from active business activities. Many investors in PTPs are passive and therefore generally would benefit from the 25% rate. The House bill would make the rate reduction permanent.

The Senate Finance bill would generally allow an individual taxpayer a deduction for 17.4% of the individual's domestic qualified business income (which is generally trade or business income but excludes certain specified service trade or businesses). The deduction would be limited to 50% of the taxpayer's share of the W-2 wages of the partnership. The limitation does not apply in the case of a taxpayer with income of $500,000 or less for married individuals filing jointly or $250,000 for other individuals, subject to certain phase-outs. The deduction would sunset after 2025.

KPMG observation

The House bill eliminates technical terminations of partnerships. This provision would generally be viewed as favorable to PTPs as technical terminations are administratively onerous. The Senate Finance bill does not address technical terminations of partnerships.

PTPs will likely find it attractive to continue to be taxed as a partnership.

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