On Tuesday, November 8, 2016, Republican nominee Donald Trump defeated Hillary Clinton to win the Presidency of the United States. Along with the election of President-elect Trump, Republicans were able to retain control of both houses of Congress. After years of discussions of potential for comprehensive tax reform, there appears to be a high probability of tax reform legislation being moved through Congress in 2017. President-elect Trump and Republicans from the House of Representatives (the House) have both produced tax reform outlines that have many similarities. These plans will impact the energy sector (oil and gas, mining and metals, and power and utilities).

On June 24, 2016, the Tax Reform Task Force, composed of House Republicans and led by House Ways and Means Committee Chairman Kevin Brady (R-TX), released a report on tax reform, the Tax Reform Task Force Blueprint (the Blueprint). The Blueprint contains a high-level tax reform proposal that, if enacted, would repeal the current US business income tax regime and replace it with a quasi-consumption tax. As described in more detail below, the Blueprint may serve as a playbook for certain tax reform changes in a Republican-controlled Congress. Below, President-elect Trump’s energy policy is explored, followed by his stated tax policy and energy tax implications of the Blueprint.
President-elect Trump's energy policy

President-elect Trump is widely expected to significantly depart from the priorities of the Obama Administration by favoring development of additional conventional energy resources and attempting to put the brakes on new environmental initiatives. The Republican (GOP) majorities in the House and Senate have a similar agenda, and Democrats in Congress are expected to mobilize in opposition—in particular by leveraging their power in the Senate to filibuster legislation—and publicly highlight the potential impacts of a Trump Administration’s policies. Trump has pledged to cancel US participation in the 2015 Paris Climate agreement, and opposes implementation of the Obama Administration’s Clean Power Plan (CPP). His campaign literature is heavily salted with proposals to provide regulatory relief to fossil fuel industries and slanted in favor of new administrative initiatives to foster conventional energy development. Specifically, his website calls for the following energy-related initiatives:

- Make America energy independent, create millions of new jobs, and protect clean air and clean water; conserve our natural habitats, reserves and resources; unleash an energy revolution that will bring vast new wealth to our country
- Declare American energy dominance a strategic economic and foreign policy goal of the United States
- Unleash America’s $50 trillion in untapped shale, oil and natural gas reserves, plus hundreds of years in clean coal reserves
- Become, and stay, totally independent of any need to import energy from the OPEC cartel or any nations hostile to our interests
- Open onshore and offshore leasing on federal lands, eliminate moratorium on coal leasing, and open shale energy deposits
- Encourage the use of natural gas and other American energy resources that will both reduce emissions but also reduce the price of energy and increase our economic output
- Rescind all job-destroying Obama executive actions
President-elect Trump has stated that he wants to reduce and eliminate all barriers to responsible energy production, creating at least half a million jobs a year, US$30 billion in higher wages and cheaper energy. Given the predominance of oil and gas, President-elect Trump may try to halt additional environmental regulatory measures proposed by the Obama Administration, such as methane emission curbs. It should be noted that it is difficult legally to change or repeal regulations which have been promulgated in final form – such as the CPP – without going through the Administrative Procedures Act process. Environmental lawyers can be expected to litigate at every step of the way if Trump attempts to bypass Congress and eliminate the CPP by executive order, and the courts may well serve as a brake on such actions. However, environmental advocates who would have likely tried to push a President Clinton to administratively expand the scope of the CPP’s carbon emission regulations beyond the electric power sector, potentially economy-wide under Section 115 of the Clean Air Act, may now be left to use a litigation route to try to force the Environmental Protection Agency to expand the CPP to achieve this goal.

During the campaign, Trump also specifically rejected the idea of using a carbon tax/carbon pricing as a means of encouraging market-driven emission reductions. With GOP chairmen of the tax-writing committees in the House and Senate, it is very unlikely they will schedule hearings or markups to move carbon taxes – other than to schedule votes in the House or Senate aimed at undermining vulnerable Democrats up for reelection in 2018.

Additionally, the President-elect has vowed to allow energy infrastructure projects, like the Keystone Pipeline and other industrial facilities which have faced denials or delays under the current Administration, to move forward. Trump has proposed a $1 trillion infrastructure plan that would rely heavily on private-public partnerships by providing a tax credit to encourage private investors to fund projects overseen by states and municipalities. As conceived by Trump’s advisors, the tax credit would apply to infrastructure projects with a dedicated source of revenue, such as toll roads, airports or utilities financed at least in part by fees paid by users. Decisions on which projects to fund would generally be left to the states.
President-elect Trump’s tax policy

The results of the presidential election have teed up comprehensive tax reform as a clear priority for the new Republican President and the Republican Congress. A unified Republican government makes the process of achieving significant tax reform much more manageable next year, in particular because House Speaker Paul Ryan (R-WI) during the campaign pledged to move such a plan in the form of so-called budget reconciliation legislation, which would mean only a simple majority of senators would be necessary to pass the plan, rather than the usual 60-vote majority.

A lot of the groundwork has been laid through proposals and negotiations over the last three or four years on various key aspects of business tax reform, but Congressional Republican leaders and the new President will have to decide whether to push forward with legislation that embodies the Blueprint, or the outlines of a tax reform plan that President-elect Trump championed during the campaign. One significant difference is that the Blueprint, according to its authors, is largely revenue neutral using dynamic scoring, while the Trump plan was scored by various nongovernmental groups as losing trillions of dollars.

House Speaker Ryan has said on multiple occasions that tax reform is his top priority. As described in more detail below, the Blueprint, the sixth and final plank of Ryan’s “Better Way” campaign to provide policy alternatives, proposed a 20% statutory corporate tax rate, a 25% business tax rate for pass-through entities, a move toward a cash-flow consumption tax through immediate expensing for all businesses and elimination of deductibility of net interest expense, a territorial international tax system, a border tax adjustment mechanism, and elimination of most business preferences except the research and development tax credit (R&D Credit) and the last-in-first-out (LIFO) method of accounting for inventories.

Interestingly, all of these pieces of business tax reform may be fair game in discussions with Democrats, but the two parties differ greatly over whether to reduce individual tax rates – a key component of both the Blueprint and the Trump campaign agenda – and over important revenue issues, including whether reform should be revenue neutral on a static basis, and whether timing and one-time revenue raisers should be used to pay for permanent tax rate reduction. The use of budget reconciliation, however, could make many of these differences irrelevant as Senate Democrats could have little power to change or block the legislation on the Senate floor.

Along with the 20% statutory corporate tax rate, the Blueprint includes a 25% business tax rate for pass-through entities, and individual rates set at 12%, 25% and 33%, as described in more detail below. The Ways and Means Republican tax staff is in the process of receiving feedback and building out the Blueprint by drafting detailed statutory language. The publicly expressed goal is to have that effort completed by the end of 2016. In October 14 remarks at the University of Wisconsin-Madison, House Speaker Ryan said, “I really want to get tax reform running as quickly as possible.” Asked September 29 whether there is opportunity for progress on big-ticket items in 2017, Senate Majority Leader Mitch McConnell (R-KY) said, “We need to do tax reform – comprehensive tax reform – not piecemeal.”

Trump’s tax plan differs from the Blueprint in that the corporate tax rate would be lower – 15% – with the same rate imposed on pass-through entities. The latest statement from the Trump campaign suggests that small business owners that do not retain earnings may face double taxation. Individual income tax rates would be 12%, 25% and 33%, the same as the Blueprint. Trump and his staff have supported a 10% tax rate on the deemed repatriation of previously untaxed foreign earnings of US companies, but the campaign never made clear whether they still support repeal of deferral in a new international tax system going forward.

Trump has pledged to work with House Republicans on tax issues and, in addition to adopting their proposed individual rates, brought his plan closer to theirs by announcing support for immediate expensing of new business investments for manufacturers. The House plan proposed expensing in conjunction with eliminating the deductibility of net interest expense. In the follow-up to a September 15 speech to the Economic Club of New York, Trump clarified he believes expensing should be limited to manufacturers and those who elect expensing will lose the deductibility of corporate interest expense. The Trump campaign also clarified in September that they favored repeal of most corporate tax expenditures, except for the R&D Credit. While continuing to call for repeal of the estate tax, Trump proposed disallowing a step-up in basis for estates over $10 million; “The Trump plan will repeal the death tax, but capital gains held until death will be subject to tax, with the first $10 million tax free as under current law to exempt small businesses and family farms. To prevent abuse, contributions of appreciated assets into a private charity established by the decedent or the decedent’s relatives will be disallowed.”

Trump additionally proposed capping itemized deductions at $100,000 for single filers and $200,000 for married filers and highlighted the benefits of his proposals for working Americans and the middle class. “By lowering rates, streamlining deductions, and simplifying the process, we will add millions and millions of new jobs. In addition, because we have strongly capped deductions for the wealthy, and closed special interest loopholes, the tax relief will be concentrated on the working and middle class taxpayer,” he said. “This is a working and middle class tax relief proposal.” A campaign fact sheet proclaims Trump’s economic proposals would add 25 million jobs over a decade, which equates to 200,000 new jobs per month.

The motivating factors for tax reform will remain the same as they were in the current Congress, but unified government should make enacting tax reform much easier. The statutory corporate income tax rate is seen as too high and the international tax system compels profit shifting to low-tax jurisdictions and erodes the US tax base.
That phenomenon escalated this year with the European Commission’s latest state aid decision, which was seen as demonstrating a tension between the United States and Europe over who should tax the foreign income of US multinationals.

The passage of the European Union’s (EU) harmful tax competition directive will lead to enactment in all EU countries of a variety of measures that could increase taxes on US companies operating in Europe, while implementation of innovation box regimes in many countries, following the Organisation for Economic Co-operation and Development’s Base Erosion and Profit Shifting project outline, will make it more attractive for US companies to move intellectual property and exploit that intellectual property into those jurisdictions. The Administration took significant steps this year to try to prevent further erosion of the US tax base through regulatory action to deter inversions and earnings stripping, but all involved said these were Band-Aid approaches that were no substitute for US tax reform.

As has been the case for the last few years, there is broad agreement on the design elements of business tax reform, and more specifically, international tax reform, but the devil is in the details. For example, the Blueprint calls for an 8.75% tax rate on previously untaxed accumulated foreign earnings held in cash or cash equivalents, and a 3.5% tax rate on all other accumulated earnings, with tax liability payable over an eight-year period. This is the same tax treatment of accumulated foreign earnings called for under former Ways and Means Committee Chairman Dave Camp’s (R-MI) Tax Reform Act of 2014.

But in a departure from the Camp bill, the Blueprint also calls for a move to a destination-basis tax system, under which border adjustments exempt exports from tax while taxing imports, making the tax jurisdiction the location of consumption rather than production. Exempting exports from US tax and taxing imports regardless of where they are produced will eliminate incentives for US businesses to move or locate operations outside of the United States under a territorial tax system, according to the Blueprint. By relieving exports from US tax while imposing US tax on imports, the Blueprint would eliminate the need for any new exemption or territorial tax system to be accompanied by a minimum tax or any other more conventional anti-base erosion measure, thereby sidestepping one of the more intractable and divisive debates among the business community over the past several years of tax reform discussions.

Developing a workable border adjustability mechanism that is not actually a component of a value-added tax presents some significant policy and technical hurdles. US companies that are net exporters could end up in a perpetual tax loss position, and handing out refunds to some of the largest US companies may not work from a political standpoint, particularly as the domestic income of US companies (including the suppliers for exporting companies) is subject to tax. How to apply the border adjustability concept to cross-border flows of capital, or whether to exempt financial transactions, must also be considered.

While moving to a form of exemption system has some level of bipartisan support, certain Democrats may insist on a more pure worldwide system that includes repeal of deferral, Senate Finance Committee Ranking Member Ron Wyden (D-OR) (intermittently) and Senator Elizabeth Warren (D-MA) (consistently) have both backed the latter approach, and Speaker Ryan noted the differing viewpoints in September given that Democrats increasingly call for a worldwide system and repeal of deferral. “There is a big gulf between our two views. ... We believe that we should have a pure territorial system. ... And so I do believe that this issue is coming,” Ryan said. “I don’t think you can stand against a territorial system much longer.” Ryan also remarked, “The experience I had when I was Ways and Means chair with [Democrats] was not a pleasant one, and I don’t know if that’s going to change.”

In a September 8 New York Times op-ed, Senator Warren said foreign developments are increasing pressure on Congress to cut corporations “a new sweetheart deal” in tax reform, but lawmakers should instead take the opportunity to collect more revenue from corporations. “Preferential tax treatment, either through special rates or deferred due dates, creates a huge financial incentive for American companies to build businesses and create jobs abroad rather than in the United States. Our tax code should favor jobs and businesses at home – period,” Warren said.

Along with these political and mechanical questions, there is the question of whether such a system, embedded in an income tax rather than a value added tax or other true consumption tax, is legal from an international trade perspective.

There may also be tension among House Republicans given the Blueprint has not had a full airing among members – it was released soon before Congress left for its summer recess – and the drafting of legislative language may make apparent what is necessary to achieve the stated goals, particularly the reduced rates: a 20% statutory corporate tax rate; a 25% business tax rate for pass-through entities; and individual rates set at 12%, 25% and 33%. Once the details are hashed out, the Blueprint could present just as many trade-offs as previous serious tax reform proposals. While the mix of winners and losers may be different than under other proposals, the ultimate fate of the Blueprint will still be determined by the same fundamental political dynamics that would face any tax reform proposal.

For example, the Blueprint would permit companies to fully and immediately deduct the cost of all tangible and intangible property, with the exception of land. However, the Blueprint also would correspondingly deny deductions for net interest expense. Companies must therefore weigh whether losing interest deductions is a cost they are willing to incur in exchange for full expensing (and a 20% corporate rate).

The purpose of denying deductions for net interest expense is to prevent a presumed double benefit from fully expensing leveraged purchases of property. However, the exclusion of land from full expensing under the Blueprint would be particularly severe for debt-
financed purchases of land because the land would not be eligible for full expensing (or apparently even depreciation as under current law), while deductions for interest expense on the debt would not be permitted. Moreover, the persistent issues under current law involving the allocation of purchase price between nondeductible land and immediately deductible improvements on the land would be intensified under the Blueprint. Other aspects of paying for a reduced corporate rate will not come easier in the new Congress. The allure of reducing business tax rates did not draw members to support the bill presented to them by former Ways and Means Chairman Dave Camp.

In the Senate, Finance Committee Chairman Orrin Hatch (R-UT) continues to go his own direction on tax reform, touting a corporate integration plan that could be a substitute for or be complementary to a rate reduction effort that includes international tax reform. Hatch says he is still aiming to release a corporate integration discussion draft. Chairman Hatch has said the proposal could accomplish the international tax reform widely seen as necessary, and the reception to the draft could dictate how strongly he tries to advance the proposal next year. The draft is expected to pair a dividends-paid deduction with a mandatory 35% withholding tax for dividends and interest. Other senators and third parties have raised concerns about a corporate integration plan, including:

- That the proposed 35% withholding tax expected would penalize tax-exempt entities like retirement plans and deter foreign investment in the United States
- That a dividends paid deduction would, by reducing corporate tax liability, diminish the effectiveness of current tax incentives like the R&D Credit and accelerated depreciation, and disadvantage start-up companies more likely to retain their earnings rather than pay dividends

Tax treaties. Action on the eight Foreign Relations Committee-approved tax treaties Senator Rand Paul (R-KY) wants renegotiated over information-sharing concerns is seen as overdue. The treaties include: new protocols amending US tax treaties with Switzerland, Luxembourg, Spain and Japan; new tax treaties with Hungary, Chile and Poland; and a multilateral convention on tax administration. There have been no plans announced for trying to move the treaties during the lame-duck session, though such an effort is possible.

State tax issues. In August, House Judiciary Committee Chairman Bob Goodlatte (R-VA) released a second discussion draft related to remote sales tax that would apply tax at the destination state of the goods, rather than on the location of the seller, which was his previous approach. The tax would be imposed at a single rate determined by the state of the purchaser, but using the tax base of the state of origin. Chairman Goodlatte wanted a vote this year on the proposal, which had the support of Speaker Ryan, but this vote is not likely to occur during the lame duck session. When Congress approved a customs reauthorization measure that made permanent the Internet Tax Freedom Act in February, Senate Majority Leader McConnell said he had provided assurances to supporters of the Marketplace Fairness Act “that we’ll have an opportunity to consider that sometime this year.” Since that is not likely to occur during the lame-duck session, the issue is sure to resurface in 2017.

In September, the House approved by voice vote the Mobile Workforce State Income Tax Simplification Act (H.R. 2315), to prohibit wages earned by an employee who performs employment duties in more than one state from being subject to income tax in any state other than: (1) the state of the employee’s residence, and (2) the state within which the employee is present and performing employment duties for more than 30 days during the calendar year.
Senate Finance Committee member John Thune (R-SD) sponsors a Senate version of the bill (S. 386), though the outlook for the issue is unclear.

**House Republican Blueprint**

As described in some detail here, the Blueprint proposes a 20% statutory corporate tax rate, a 25% business tax rate for pass-through entities, a move toward a cash-flow consumption tax through immediate expensing of plant and equipment for all businesses and elimination of deductibility of net interest expense, a territorial international tax system, a border adjustment mechanism and the elimination of most business tax preferences (except the R&D Credit and the LIFO method of accounting). If enacted, the Blueprint would likely impact both the economics and tax burden of a taxpayer in the energy sector (oil and gas, power and utilities, and mining and metals industries).

The Blueprint contains three primary elements: a tax on wages, a tax on investment income and a cash-flow tax. The tax on wages and the tax on investment income are levied upon the individual, whereas the cash-flow tax is levied upon businesses, including sole proprietorships, pass-through entities and corporations. Taken together, these three elements result in a quasi-consumption tax. The commentary below primarily explores how the cash-flow tax element may affect a taxpayer in the energy sector.

In general, the proposed cash-flow tax base would equal a business’s sales to customers in the United States plus interest income less purchases from other businesses, interest expense (limited to the amount of interest income), wages paid and capital expenditures (excluding land). A taxpayer could carry forward interest expense that exceeds interest income and deduct the amount carried forward against interest income in future years. Under the Blueprint, a taxpayer would not be permitted to carry back an excess net operating loss (NOL) but would be permitted to carry the excess NOL forward indefinitely for use in future years. The maximum NOL carryforward deduction in any year, however, would be limited to 90% of taxable cash flow and would be increased by an interest factor. As described above, the cash-flow tax would be imposed at a flat 20% rate on corporations and at a 25% rate for sole proprietorships and pass-through entities.

The Blueprint would preserve the LIFO method of accounting for inventory and would retain the R&D Credit. The Blueprint, however, appears to eliminate all other deductions and credits (for example, the Section 199 domestic production deduction). In addition, the Blueprint would eliminate the alternative minimum tax (the AMT).

With respect to international taxation, the Blueprint proposes the use of a destination-based territorial tax system, under which sales to customers located in the United States would be included in the tax base and sales to customers located outside the United States may be excluded from the tax base. The Blueprint also provides a 100% exemption for dividends received from foreign subsidiaries.

In addition, accumulated foreign earnings would be subject to an 8.75% tax, to the extent held in cash or cash equivalents, or a 3.5% tax, to the extent not held in cash or cash equivalents, which would be payable over an eight-year period. (President-elect Trump’s plan has called for a 10% tax on accumulated foreign earnings.) Finally, the Blueprint would eliminate the subpart F rules, with the exception of the foreign personal holding company rules.

With the destination-based territorial tax system, the Blueprint business tax contains a border adjustability element, pursuant to which business income taxes would be “border adjusted.” While this concept has not been fully articulated by House Republicans, it appears that the border adjustment would disallow the deduction for the cost of imported products, and businesses would not have to include revenues from sales outside of the United States.

The House Republicans intend the Blueprint to be revenue neutral. For a variety of reasons beyond the scope of this article, it is not clear whether the Blueprint is in fact revenue neutral. Nevertheless, it is clear the Blueprint, if enacted in its current form, would shift the tax burden across business sectors, thereby changing the economics of those business sectors.

**Oil and gas sector**

*Intangible drilling and development costs*

Intangible drilling and development costs (IDCs) are expenses that are incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and gas that have no salvage value. IDCs generally include the cost of survey work, ground clearing, drainage, wages, fuel, repairs, supplies and related costs incurred before well completion. Under current law, an independent oil and gas producer may deduct 100% of IDCs in the year the independent producer incurs the cost. An integrated oil and gas producer, however, may deduct 70% of the IDCs in the year it incurs the cost and may amortize the remaining 30% over a 60-month period beginning with the month in which the costs are paid or incurred.

The Blueprint appears to allow both an independent producer and an integrated producer to deduct 100% of IDCs in the year such costs are paid or incurred. Because an independent producer is currently allowed to deduct 100% of IDCs in the year paid or incurred, it does not appear the Blueprint would directly alter the economics associated with oil and gas wells for an independent producer. In contrast, the Blueprint appears to permit an integrated oil and gas company to also deduct 100% of IDCs in the year paid or incurred. Thus, it appears the Blueprint could increase the discounted cash flow and the rate of return on oil and gas wells drilled by an integrated oil and gas company. By potentially equalizing the tax treatment with respect to IDCs, an independent producer may lose an economic advantage vis-à-vis an integrated oil and gas company. This change may ultimately make an independent producer less competitive with an integrated oil and gas company because an integrated oil and gas company may have a lower borrowing cost than a small independent producer.
**Dual capacity for international earnings**

A dual capacity taxpayer is subject to a levy from a foreign jurisdiction and also receives an economic benefit (e.g., the right to use, acquire or extract a natural resource) from the jurisdiction. Under current law, a dual capacity taxpayer can only claim a foreign tax credit for a payment made to a foreign jurisdiction that qualifies as an income tax as defined by US tax law. The dual capacity taxpayer bears the burden of proof that the foreign levy it paid was an income tax, as opposed to a royalty or other type of fee. If the dual capacity taxpayer cannot satisfy the burden of proof, the taxpayer may not receive a credit for the portion of the payment that does not qualify as an income tax. The Blueprint would replace the US corporate income tax on worldwide earnings with a territorial cash-flow tax. Thus, a domestic oil and gas producer would only pay tax upon its sales of oil and gas to a customer in the United States. Therefore, under the Blueprint, it appears both an independent producer or a royalty owner that owns an economic interest in an oil or gas property in the property over time. Under current law, an independent producer can claim a percentage depletion deduction using a rate of 15% of the gross income from the property based on the independent producer's average daily production of domestic crude oil or domestic natural gas up to its depletable oil or natural gas quantity. Because percentage depletion is measured by gross income, a taxpayer that uses percentage depletion need not quantify the costs associated with the deduction. In addition, there is no dollar limit on the percentage depletion deduction. Therefore, the cumulative percentage depletion deduction may exceed the cost of acquiring the well. An integrated oil and gas company may not claim a percentage depletion deduction.

Under the Blueprint, it appears both an independent producer and an integrated oil and gas company may deduct any costs associated with acquiring an oil or gas property in the year incurred. As a result, under the Blueprint, if enacted in its current form, an independent producer may no longer have a competitive advantage over an integrated oil and gas company created by percentage depletion. The accelerated deduction may increase a property’s rate of return, but an independent producer will no longer be permitted to claim deductions that exceed the cost of acquiring the property. Thus, the economic impact of the loss of percentage depletion for an independent producer coupled with the ability to deduct all costs associated with the oil or gas property for both an independent and an integrated oil and gas company depends upon each taxpayer’s facts and circumstances.

**Border adjustability**

The Blueprint does not provide full details on the border adjustability concept; however, the concept, if enacted in its current form, could have significant impacts for upstream and downstream taxpayers. The border adjustment would disallow deductions for imported products. This would have immediate impacts on gulf coast refiners that rely on imported crude oil to produce refined products. However, the concept appears to provide a benefit for taxpayers who export crude oil or refined products. Revenues from exports would not be included in the US tax base. It is uncertain how these changes would impact the global commodities markets for refined products and crude oil.

**Repatriation of foreign earnings**

For oil and gas taxpayers with significant foreign operations and un-repatriated foreign accumulated earnings, both the Blueprint and President-elect Trump's tax framework include deemed repatriation elements. The Blueprint allows for two separate rates on accumulated foreign earnings, an 8.75% rate on earnings held in cash or cash equivalents, and a 3.5% rate for earnings not held in cash or cash equivalents. The President-elect's proposal has called for a 10% tax on accumulated foreign earnings. With the intention of moving toward a territorial tax regime, any tax reform legislation brought to a vote may include a repatriation tax.

**AMT tax preferences**

The AMT is a separate and parallel system from the regular US federal income tax. Under current law, if a taxpayer’s AMT liability exceeds the amount of US federal income tax the taxpayer would otherwise owe, a taxpayer must pay a flat-rate 20% AMT. A taxpayer’s AMT base is determined with reference to the taxpayer’s income tax base, which is increased or decreased by AMT “adjustments” and increased by AMT “preferences.” For the oil and gas industry, AMT adjustments and preferences include IDCs, excess percentage depletion, the LIFO method of computing costs of goods sold, depreciation and adjusted current earnings. If a taxpayer pays AMT, the taxpayer receives an AMT credit, equal to the amount of AMT paid, which it may use to offset its regular income tax liability in future years.

The Blueprint does not discuss specific transition rules. Rather, it states that any proposed legislation will contain clear transition rules that will be drafted with the input of stakeholders. Thus, it is not clear whether the legislation that would implement the Blueprint would contain a transition rule that allows a taxpayer to monetize or otherwise utilize existing AMT credits the taxpayer may have at the time the transition would occur. An oil and gas sector taxpayer with significant AMT credits should carefully monitor any proposed legislation associated with the Blueprint to determine whether the legislation contains appropriate transition rules.
Power and utilities sector

Interest expense deduction

Currently, a taxpayer may deduct the interest expense it paid or accrued on its indebtedness. A regulated public utility recovers its interest expense as part of its overall return on invested capital. The use of debt in a regulated utility's capital structure decreases the utility's rates because the utility may deduct its interest expense for US federal income tax purposes. The equity portion of a utility's capital structure generally results in higher rates because the after-tax return on equity has no corresponding tax deduction.

Under the Blueprint's proposed cash-flow tax, a taxpayer may only deduct interest expense to the extent of the taxpayer's interest income. In response, it is likely that a regulator would gross-up a regulated utility's return on rate base for both the debt and the equity portions of the utility's capital structure. Such a gross-up would increase the utility's rates. Moreover, the changing cost of debt that results from the loss of the interest deduction may cause a regulator to reconsider what constitutes an appropriate capital structure for a utility. Taken together, these regulatory actions would likely increase the rate a utility charges its customers and may accelerate the arrival of “grid parity,” which occurs when a customer’s cost of generating its own electricity equals the rates it pays for electricity, and ultimately reduce the utility's customer base. Thus, this element of the proposed cash-flow tax may have a significant effect upon a regulated utility and its ratepayers.

Capital expenditure deduction

Currently, the tax law allows a utility to claim accelerated depreciation. To prevent accelerated depreciation from becoming a federal subsidy to the utility's ratepayers, for ratemaking purposes, Congress requires a utility to use the normalization method of accounting. Under the normalization method of accounting, a utility computes the US federal income tax expense included in its costs of service as if the utility used the same depreciation method for US federal income tax purposes that the utility uses for financial accounting purposes. The normalization method of accounting also allows a utility to include the deferred tax liability associated with accelerated depreciation as a decrease to the utility's rate base. In addition to accelerated depreciation, the current tax law permits a taxpayer to elect to claim a special depreciation allowance – bonus depreciation on certain property.

Under the Blueprint, a utility would be required to deduct 100% of its capital expenditures in the year incurred. The Blueprint does not discuss whether it envisions requiring a utility to compute the US federal income tax expense included in its costs of service using the normalization method of accounting. If Congress does not enact a normalization rule as part of the cash-flow tax, Congress will effectively create a significant federal subsidy for a utility's current customers by allowing a regulator to pass through the tax benefit associated with a utility's capital investments to the utility's ratepayers in the year the assets are placed in service, as opposed to flowing the benefit through to the utility's current and future ratepayers over the life of the asset.

For the past several years, many utilities have incurred NOLs for US federal income tax purposes as a result of the bonus depreciation. The normalization method of accounting requires a utility to include the portion of an NOL associated with accelerated depreciation as an increase to the rate base. Under the Blueprint, it is likely that the 100% capital expenditure deduction would cause many utilities to be in an NOL position. If Congress enacts a normalization rule as part of the cash-flow tax, the deferred tax assets associated those NOLs and the deferred tax liability associated with the capital expenditure deduction would offset each other in the utility's rate base. Absent this rule, a regulator could ignore the economic effects of an NOL and effectively reduce a utility's earnings.

Research and development credits

Until December 2015, the R&D Credit contained in Internal Revenue Code Section 41 was not permanent and there was no certainty whether the credit would be available in future years. On December 18, 2015, H.R. 2029, the Protecting Americans from Tax Hikes Act of 2015 made the Section 41 credit permanent, thereby giving a utility certainty that a research and development credit built into the utility's rates will be available in the years between rate cases.

The Blueprint proposes retaining the permanent R&D Credit. Thus, a utility may plan a long-term research project with the certainty that the benefit related to the R&D Credit will be available. This certainty may also allow a utility to build the R&D Credit into its rates because the credit will be available in years between rate cases.

Excess deferred taxes and transition rules

As noted above, the Blueprint does not contain details on the contents of any proposed transition rules. Rather, it states that any proposed legislation will contain clear transition rules that will be drafted with the input of stakeholders. When a reduction in tax rate occurs, a taxpayer must recalculate its deferred tax reserves. A reduction in tax rate results in excess deferred tax reserves. A normal subchapter C corporation is required to recognize the excess deferred tax reserve in income, but a utility generally must refund the excess deferred tax reserves related to accelerated depreciation to its customers.

For a utility, the issue related to refunding the excess deferred tax reserves is the timing of the payments to its customers. An immediate refund of the entire amount may significantly reduce the utility's cash flow. In 1986, when Congress last enacted a comprehensive tax reform package, Congress enacted legislation that spread the benefit of the refund to utility customers over the remaining useful lives of the assets. To avoid the negative consequences associated with an immediate refund of excess deferred taxes, a utility should monitor the draft of tax reform legislation associated with the Blueprint and ensure that legislation contains an appropriate transition rule.
Mining and metals sector

Percentage depletion and AMT

Because the percentage depletion limitations imposed upon a taxpayer in the oil and gas industry are not applicable to a taxpayer in the mining industry, percentage depletion is more significant to the mining industry. Under the current US federal income tax law, a taxpayer in the mining industry may claim percentage depletion to recover its capital investment in a mineral property equal to the lesser of a stated percentage of “gross income from mining” or 50% of “net income from mining.” Because percentage depletion is based upon the taxpayer’s net income and not the cost of the mineral property, over time a taxpayer may claim a cumulative percentage depletion deduction that exceeds the cost of the mineral property, i.e., excess percentage depletion. This excess percentage depletion results in required adjustments in calculating AMT, and, consequently, a taxpayer in the mining industry typically pays AMT in excess of its regular US federal income tax liability. Under the Blueprint’s proposed cash-flow tax, percentage depletion would no longer be available. As a result, the unavailability of the excess percentage depletion deduction could reduce the rate of return and the cash flow of a mineral property. The economic consequences related to the lack of percentage depletion may be offset by the increased rate of return and the reduced cost of capital that result from the immediate deduction of capital expenditures associated with acquiring and operating the mineral property.

Capital expenditure deduction

The mining and metals industry is a capital-intensive industry. Thus, the immediate expensing of capital equipment would be a significant benefit. Historically, a mining industry taxpayer eligible for accelerated or bonus depreciation had to weigh the benefits of accelerated or bonus depreciation against the potential loss of percentage depletion. With the elimination of percentage depletion, the immediate expensing of capital equipment would be a significant benefit. The immediate expensing of capital investment expenditures may put many taxpayers in the mining and metals industry in an NOL position, at least initially. Nevertheless, it is also important to note that the Blueprint, if enacted, would only permit a taxpayer to offset 90% of the cash-flow tax base by an NOL generated in an earlier year, which could result in a mining and metals taxpayer owing a cash-flow liability even though it has a remaining NOL carryforward.

Similar to current depreciation rules, the Blueprint would not permit a taxpayer to deduct the cost of land. In contrast to the current US federal income tax regime, the Blueprint appears to allow a taxpayer to immediately deduct the cost of purchasing intangible property. In the mining and metals industry, in many instances the purchase of land includes the intangible mineral rights associated with the land. The Blueprint does not make clear whether a taxpayer that purchases land and the associated mineral rights in a single transaction may segregate and deduct the cost of the mineral rights included in the purchase price of the land. If the Blueprint does not segregate and deduct the cost of the mineral rights included in the purchase price of land, a taxpayer in the mining and metals sector would realize a decreased rate of return and cash flow on the mineral property due to its inability to claim a percentage depletion deduction under the proposed cash-flow tax.

R&D Credit

Historically, taxpayers in the mining and metals industry have often paid AMT and may not have always been in a position to recognize the benefits of research and development credits, since these credits were not creditable against the AMT. The combination of the elimination of percentage depletion and the elimination of AMT could create an opportunity for a mining and metals taxpayer to review its activities that may qualify for the R&D Credit.

AMT credits and transition rules

As explained above, the Blueprint does not mention specific transition rules. Rather, it states that any proposed legislation will contain clear transition rules that will be drafted with the input of stakeholders. Thus, it is not clear whether the legislation that would implement the Blueprint would contain a transition rule that allows a taxpayer to monetize or otherwise utilize existing AMT credits the taxpayer may have at the time the transition would occur. A mining and metals sector taxpayer with significant AMT credits should carefully monitor any proposed legislation associated with the Blueprint to determine whether the legislation contains appropriate transition rules.

Conclusion

With the election of Donald Trump, the Republicans retaining control of Congress, House Speaker Paul Ryan’s (R-WI) commitment to bringing tax reform to vote in 2017, and the development of the Blueprint, there finally appears to be a legislative path forward for tax reform. The House Ways and Means Committee will now shift its attention to working with the income Administration to produce tax reform legislation. During the drafting process, the Committee will continue to seek feedback from stakeholders. The Committee has indicated that any transition rules will be drafted with the input of stakeholders.

President-elect Trump’s tax reform plans generally adhere to the precepts of the House Republican Tax Reform Blueprint, but his plans differ from that outline in some important respects. As described above, the Blueprint proposes, among other things, to allow 100% expensing of qualified business investments and to deny the deductibility of net business interest expenses. It would also eliminate most fossil-fuel-specific tax incentives such as deductions for IDCs and percentage depletion, but its proposal to allow expensing of all business investment would mitigate the loss of many of the specific deductions. Trump offered qualified support for the Blueprint’s proposal to allow 100% expensing — but would limit the provision to manufacturers — and those who elect expensing would lose the deductibility of business interest expenses.
While President-elect Trump has spent much of his time discussing federal policy issues surrounding conventional energy resources, he has expressed opposition to continued federal support for the development of wind and solar energy and has said he will eliminate all federal spending for clean energy research. How he proceeds in the new Congress may be heavily influenced by both electoral politics (e.g., ethanol-rich Iowa largely supported his candidacy) and the pre-existing dynamics in Congress. Many Congressional Republicans have opposed even temporary extensions of renewable energy incentives and the fate of these provisions may well be linked to the effectiveness of the Democratic minority.

As demonstrated by the examples above, tax reform could have significant impact on the economics of a taxpayer in the energy sector, and, as a result, an energy sector taxpayer should attempt to quantify the potential tax and economic effects of potential tax reform on their business and actively engage in the legislative process.
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