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GOP tax reform framework: An oil and gas lens

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Oil and gas companies and investors continue to monitor tax reform developments to gauge the potential impact on the oil and gas industry. While broad based tax reform would impact all industries, its evolution and progress is of specific interest to the oil and gas industry due to the myriad of special provisions in the tax code impacting oil and gas companies.

The "Big Six"[1] negotiating team of congressional Republican leaders and White House officials released a long-awaited tax reform framework on September 27 that calls for ambitious cuts to tax rates for corporations, passthrough entities,

[1] Members of the Big Six include House Ways and Means Committee Chairman Kevin Brady, R-Texas, Senate Finance Committee Chairman Orrin Hatch, R-Utah, House Speaker Paul Ryan, R-Wis., Senate Majority Leader Mitch McConnell, R-Ky., Treasury Secretary Steven Mnuchin, and National Economic Council Director Gary Cohn.

and individuals; a more generous – albeit temporary – expensing regime; significant increases to the individual standard deduction and the child tax credit; and repeal of the estate tax and the individual alternative minimum tax.

But even though the plan contemplates that tax reform will result in the modification, scaling back, or outright repeal of many current-law business and individual tax incentives, it provides relatively few specifics on the policy tradeoffs that will be necessary to enact reform within the confines of budget rules that prohibit legislation moved under fasttrack reconciliation protections from increasing the federal deficit outside the 10-year budget window.

While perhaps foreshadowing the potential impact on a number of key provisions relevant to oil and gas companies, the framework lacks details on a number of important provisions that are potentially impactful to many oil and gas companies. These details will obviously be critical as this tax reform discussion evolves.

Business provisions

In general, the framework calls for restructuring the business tax rules to create a more competitive environment for large and small businesses alike.

Corporate rate reductions: The framework calls for reducing the US statutory corporate rate from 35 percent down to 20 percent, which would place the US below the OECD average of 22.5 percent. President Trump had pushed for a rate of 15 percent, however most members of the Big Six indicated in public comments in recent weeks that a 15 percent corporate rate would be unrealistic given the large revenue loss associated with that level of rate reduction.

Integration in the mix?: The framework also leaves the door open for a corporate integration proposal – an approach favored by Finance Committee Chairman Hatch – noting that the congressional taxwriting committees "may consider methods to reduce the double taxation of corporate earnings." (Hatch has been an outspoken advocate of corporate integration and has spent considerable time over the past few years developing a plan that would couple a dividends-paid deduction with a withholding tax on both interest and dividend payments, although he has not released a formal proposal. Senate taxwriter John Thune, R-S.D., recently told reporters that a Finance Committee tax reform bill could include a "partial corporate integration" plan that likely would not have a withholding component.)

Corporate AMT: Under the framework, the corporate alternative minimum tax would be repealed, though no mechanism is specified for dealing with existing AMT credits.

Passthroughs: The framework calls for a top rate of 25 percent on "small businesses" – defined as a business organized as a sole proprietorship, partnership, or S corporation – which are currently taxed on the individual side of the code. To address concerns that a special passthrough rate will lead to gaming, the framework also says that the taxwriting committees will be tasked with drafting rules to prevent recharacterization of wage income as partnership income. The framework does not, however, provide guidelines for what those anti-abuse rules should look like, though in the past, Secretary Mnuchin has commented that the lower rate will not be available for professional services income.

Treatment of capital expenditures, net interest expenses: The framework would allow businesses to immediately write off 100 percent of the cost of new capital investments – other than structures – for "at least five years," effective for investments after September 27, 2017. Although the framework does not specifically address the many special rules that impact the cost recovery of capital costs incurred by upstream oil and gas companies, presumably most costs currently recovered on an accelerated basis under these special provisions would qualify for this immediate expensing. Additional guidance is needed to confirm this presumption, however.

The ability of C corporations to deduct net interest expenses would be "partially limited"; however, the framework leaves it to the taxwriting committees to determine how any limitations will operate.

Changes to business incentives: According to the framework, the substantial reduction in marginal business tax rates will eliminate the need for additional business incentives so many will be pared back or repealed.

Although it generally does not elaborate on the fate of specific current-law business tax incentives, the framework explicitly identifies the section 199 deduction for domestic manufacturing activity as a target for repeal. It also specifically calls for retaining current-law credits for research and development and for low income-housing.

Credits for specific industries: The framework states without further elaboration that the taxwriting committees will look to "modernize" rules governing the tax treatment of "certain industries and sectors" to ensure "that the tax code better reflects economic reality and that such rules provide little opportunity for tax avoidance."

The framework's references to the possibility of changes to business incentives and tax rules affecting specific industries will obviously draw the keen interest of many oil and gas taxpayers in light of the myriad of rules that have evolved over the years that are specific to the industry.

International taxation

For US multinationals, the framework proposes switching from a worldwide system, where all profits are subject to the US statutory rate upon repatriation regardless of where they were earned, to a territorial system that provides for a 100 percent exemption for dividends paid by a foreign subsidiary to a US parent with at least 10 percent ownership.

Deemed repatriation: To transition to the new system, accumulated overseas earnings would be deemed repatriated and taxed over an unspecified period at one of two rates (one for earnings held in illiquid assets and one for cash or cash equivalents). The framework does not specify the rates, but presumably, as in prior proposals, the rate for cash and cash equivalents will be higher.

Minimum tax: The framework calls for "rules to protect the US tax base by taxing at a reduced rate on a global basis the foreign profits of US multinational corporations," but leaves the specifics of those rules – including the applicable rate – to the taxwriting committees.

Ambitions of the framework meet reality of budget rules

A critical aspect of tax reform missing from the framework is its overall net impact on the federal budget. Taken together, it is likely that the revenue-losing policies enumerated in the plan – including the reduced rates on individual, corporate, and passthrough business income, enhanced expensing, the territorial system, plus the repeal of the corporate and individual AMT and the estate tax – would cost several trillion dollars over the next decade.

But under the special legislative process Republicans are eyeing to move a tax bill through the Senate on a simple majority basis – i.e., "budget reconciliation" – legislation generally cannot increase the deficit in any year beyond the budget window (which is typically 10 years), lest it be subject to procedural hurdles under the "Byrd Rule" that require 60 votes to waive. (Because Republicans currently control 52 of 100 Senate seats and more-than-token Democratic support for a tax reform bill that follows these general contours is not anticipated, Byrd Rule waivers presently seem very unlikely.)

In practical terms, this means Republicans eventually also must identify several trillion dollars' worth of revenue raising provisions (in addition to the few alluded to in the framework such as partially limiting interest deductibility for C corporations, repealing the section 199 domestic manufacturing deduction, and repealing the itemized deduction for state and local taxes) if they want to enact the framework's tax cuts on a permanent basis – or, absent that, scale back their tax-cutting ambitions to something they are, in fact, able to fully finance over the long-run.

Another possibility, which has been alluded to by Republican leaders including Speaker Ryan, would be to sunset certain revenue-losing provisions such that they no longer score as deficit-increasing over the long run, perhaps with the hope that a future Congress and president would act to extend them further, or even make them permanent – similar to what ultimately occurred with respect to a large share of the individual tax cuts originally passed under budget reconciliation in 2001 and 2003.

Challenges for the taxwriting committees

With the release of the framework, it now falls to the congressional taxwriting committees to turn the high-level guidance into legislative language – filling in the gaps in a way that ensures the bill meets budgetary requirements and crafting the complex but crucial transition rules.

While the recently released framework provides incremental information about a potential path forward and its potential impact on oil and gas businesses, it raises as many questions as it answers. As the journey towards potential tax reform continues, it will be imperative that industry stakeholders continue to closely monitor developments to ensure that appropriate actions are taken to proactively prepare for any ultimate legislative changes.

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