Energy Sector Faces Uncertainty Under Tax Reform, Panelists Say

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By Jonathan Curry

As Republicans continue to seek consensus on a tax reform plan, professionals in the energy sector are examining the proposals coming out of the House, Senate, and White House for clues regarding how their industry will be affected — and some are concerned by what they’re seeing.

“We’re looking for the tax system to not be a drain on economic growth, but to be an engine of growth,” Greg Matlock of EY said at a June 21 tax reform panel in Houston hosted by Tax Analysts and the American Bar Foundation. But even within the energy sector, which encompasses subsectors like oil and gas, mining and metals, power and utilities, and renewables, the different industries’ priorities for tax reform are diverse and they have “different things keeping them up at night,” Matlock said.

Mixed Bag

Some proposals, like the House Republicans’ blueprint, call for allowing full expensing as a way to stimulate capital investment, but Matlock argued that even in capital-reliant energy sectors, that might not have much of a stimulative effect. Under current law, upstream companies, such as those involved in drilling and exploration in the oil and gas and mining and metals sectors, are already able to qualify 85 to 95 percent of their capital expenses as intangible drilling and development costs and deduct those, Matlock said. House Ways and Means Committee Chair Kevin Brady, R-Texas, has indicated his intention is to continue to include independent drilling costs in the expensing rules, according to Matlock, but he added that there’s “a lot that’s on the table, [and] none of that is written down.”

David S. Peck of Vinson & Elkins LLP agreed that full expensing essentially already exists for upstream companies, so it would likely offer them little benefit. A midstream or downstream company like an oil refinery, which is also a capital-intensive business, could benefit from expensing, but because of bonus depreciation and accelerated depreciation under existing law, “there’s been a lot of deductions taken early.” Expensing in those cases “isn’t something that really moves the needle,” Peck said.

Expensing would also do little to help private-equity-backed companies in the energy sector, Peck said. They tend not to generate income for a period because they make big capital investments upfront for expenses like drilling and construction, so there is little to no revenue early on. But once revenue starts coming in, a sale transaction takes place, and “a lot of times we don’t get to net positive income even under current law” before that transaction, he said.
Meanwhile, the House Republicans’ proposal to disallow the net interest deduction would be “significantly problematic” to power and utility companies because debt is their primary form of capital, according to Matlock. And eliminating the state and local tax deduction would be a “big deal” for power and utility companies because they are “significant state and local taxpayers.”

The net interest deduction is also important to private equity funds, which are “big users of debt,” and disallowing it could result in higher taxes for them, Peck said. Mark Humphrey, senior vice president for Koch Industries, said the Joint Committee on Taxation has estimated that the deduction loses about $300 billion in revenue. “In the context of the numbers we’re talking about, it’s not that expensive,” he said, adding, “With what we’re gaining from it and the destruction [repeal would cause], it may well be that we’re better off leaving it alone.”

Another lingering question about interest deductibility is whether existing debt would be grandfathered. “The last we heard . . . is that grandfathering is still in play,” Matlock said. But he reiterated that, like the exceptions for small businesses, real estate purchases, and utilities, “all of this is prospective.” Christine L. Vaughn of Vinson & Elkins LLP also offered a cautious take, suggesting that if lawmakers are operating within a revenue-neutral framework “and they’re looking for another thing to dial, you might see some kind of phase-in of the lack of deductibility on your existing debt.”

Matlock said the renewable energy sector, which is largely driven by tax credits, also faces a great deal of uncertainty. The Trump administration tax plan doesn’t address it at all, except to say that many special interest tax breaks would be eliminated, and House Republican lawmakers seem to echo that sentiment. But the Senate appears to be “absolutely focused on this,” suggesting that they’ll preserve those incentives, he said.

Humphrey likewise expressed concern that some tax reform proposals, particularly in the House blueprint, could cause unfavorable economic shifts in the energy sector.

“All we think they’re doing something wrong with the border-adjustable tax and expensing,” Humphrey said. The border-adjustable tax shifts the burden of tax from businesses to consumers, he said, citing internal models and third-party studies that say the price of gasoline would spike under such a tax. Humphrey also said that the border-adjustable tax appears to be unconstitutional, and in his view is “on its death rattle.”

Instead of trying to adopt a fundamental change in the tax system, Humphrey said lawmakers should focus on reducing tax rates. “Rate cuts don’t discriminate . . . [because] everybody gets the benefit,” he said, adding, “The border-adjustable tax picks winners and losers, rate cuts don’t.”

Bret Wells of the University of Houston Law Center echoed that point, noting that energy investments are typically made in passthrough businesses “because a buyer wants to get step-up basis.” But if the corporate rate is reduced, the value of that step up in basis is reduced. “As the rate comes down, maybe you see more energy transactions . . . that end up as C-corporations,” Wells said.

Humphrey also criticized the push for full expensing, saying it wasn’t clear to him which industry was “leading the charge on this.” Expensing would be expensive, and it wouldn’t have the desired economic effect, he said. “It’s losing revenue without really generating economic
benefits."

But one proposal that would be beneficial without tradeoffs in the energy sector is repeal of the alternative minimum tax. “A lot of the fossil fuel incentives are also preferenced items in the AMT that get reversed out,” Peck said.

Corporate Integration Is Key

The corporate integration plan developed by Senate Finance Committee Chair Orrin G. Hatch, R-Utah, may not be at the forefront of the general tax reform discussion, but according to Wells it may be the “key to solve the passthrough entity problem.”

Hatch’s original plan proposed allowing a corporate-level dividends paid deduction for all distributed earnings, and included a shareholder withholding tax, but the plan ran into trouble with tax-exempt and foreign investors. But Wells said there is an alternative corporate integration plan that would allow a partial dividends paid deduction of 40 percent, because 60 percent of investors are typically tax exempt.

Wells said the partial integration approach has the additional advantage of meeting the 15 percent business tax rate target set by the Trump administration. “If there’s a 25 percent corporate tax rate, and distributed earnings can get . . . a 40 percent deduction, that provides another 10 percentage point benefit. It’s no coincidence that that’s a 15 percent rate,” he said, and it achieves that rate “in a way that is significantly less costly from the federal government’s perspective.”

He added that the partial integration approach is “actively being considered by the Senate Finance Committee, and they see that as a viable alternative to solve the passthrough problem.”

Territorial Taxation and Base Erosion

Many details remain under discussion, but one area of consensus among Republican policymakers is to switch from a worldwide to a territorial tax regime, as most other developed countries have done.

But territorial taxation is “a double-edge sword,” according to Wells. Territoriality “provides competitive neutrality in an outbound context,” he said, but it also “motivates U.S. multinational corporations to find planning techniques to shift their U.S.-origin profits to non-U.S. tax sources so that they’re outside of U.S. territorial taxation.” It also provides an incentive for U.S. multinationals to claim their expenses are U.S.-sourced so that they are counted toward their U.S. tax liability. “The gamesmanship in a territorial tax regime is obvious,” and practitioners should “expect robust anti-earnings stripping base protection measures,” Wells said.

Wells dismissed the feasibility of retaining the worldwide tax system and adopting a low foreign minimum tax instead of going to a fully territorial tax system. “The taxpayer chooses the ultimate jurisdiction of the parent company,” he said, adding that it may not happen
immediately, or it may require mergers and acquisitions to get there. “At the end of the day, I can have my residency jurisdiction in a place that’s not going to tax on a residual basis. . . . If I can’t invert, I will know that my competitors who can invert will have a structural, sustainable advantage for their offshore profits,” he said.

Wells also said that the base erosion concerns are in many ways a self-inflicted wound. Early tax treaties were based on allowing profits to go to the country of residence, “and when we were a capital-exporting nation, we loved that answer . . . we find ourselves in a different posture today, hoisted on a petard of our own making,” he said.

Expectations Meet Reality

Although Trump administration officials and Republicans in Congress still almost uniformly predict tax reform will happen before 2017 is over, the panelists considered that expectation to be overly optimistic.

There are a limited number of legislative days remaining on the calendar in Congress, with numerous other legislative priorities, like a debt ceiling vote, that have to be dealt with, Vaughn said. Procedurally, tax reform also must wait for healthcare reform to be enacted so that Congress can pass a new budget resolution with fiscal 2018 reconciliation instructions for tax reform, she said. “I think it’s possible to make major progress” in 2017, but actually passing something likely wouldn’t happen until early 2018, Vaughn said. She added that the Trump administration clearly still wants to notch political victories, and said there still appears to be a strong desire to get it done.

Matlock added that tax reform by the end of 2017 seems unlikely, but that the 2018 midterms would likely put pressure on Republican leaders to act before then. Whether comprehensive tax reform or a less ambitious tax cut, “there will absolutely be something,” he said.

Humphrey suggested that the odds of passing tax reform in 2017 are “a coin flip,” but he noted the deepening consensus around territorial taxation, and said that if lawmakers drop the border-adjustable tax and expensing and keep interest deductibility, there’s a “pretty clear path to getting this done and getting the support of the business community."

Wells, however, predicted Republicans may take an even narrower approach and simply enact business-only tax reform. He acknowledged that that would be a departure from what Republicans have been promising, including in comments by House Speaker Paul D. Ryan, R-Wis., a day earlier, when he said tax reform would apply both to individuals and businesses. But Wells insisted that, while it would be painful for the administration to back away from President Trump’s campaign promise, “you need to get votes [and] individual taxes is a minefield when you start dealing with the give and take.”

“Let’s achieve what we can achieve,” Wells said. “It doesn’t have to look like 1986.”