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What House And Senate Tax Bills Mean For Oil And Gas Cos.

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As has been widely reported, House and Senate Republicans have proposed and debated tax reform bills, with the House version having passed on Nov. 16, 2017, and the Senate version having passed on Dec. 2, 2017.

Both bills will be further debated and revised through a Conference Committee among House and Senate Republicans before going back to each of the House and Senate for a final vote.

Both bills are extremely long (weighing in at over 400 pages each) and cover a wide range of issues. Players in the domestic oil and gas space (energy companies, private equity investors, investment bankers and lenders) will be wise to take note of the following material features of these bills.

It's All About Those Rates

Both bills cut the corporate tax rate to 20 percent while leaving dividend and capital gains rates unchanged. When accounting for both the corporate-level tax and the long-term capital gain or dividend tax at the shareholder level, this change reduces the amount of federal income tax imposed on every $100 of corporate earnings from $50.47 to $39.04 after taking into account all federal income taxes, including the 3.8 percent tax imposed on net investment income for high income taxpayers imposed by the Affordable Care Act (the NIIT).[1]

Tax on $100 of Earnings			
	Current Law	House Bill	Senate Bill
Corporations & Shareholders	$50.47	$39.04	$39.04
Passive Investors in Partnerships	$43.40	$28.80	as low as $33.50
Active Investors in Partnerships	$43.40	as high as $39.02	as low as $33.50
Partners in Service Partnerships	$43.40	$43.40	$42.30

However, the tax treatment for pass-through earnings, such as income from a K-1 earned by passive investors in a private equity investment or a master limited partnership (MLP), differs and is decidedly more advantaged in the House bill than in the Senate bill.

In the House bill, passive investors (like MLP common unit holders in the public markets) enjoy a low 25 percent rate on partnership income, which, when combined with the NIIT, results in $28.80 of tax for every $100 of income.

The House bill treats active investors (e.g., management) differently, imposing a blended rate of tax: 25 percent on at least 30 percent of the income,[2] and the ordinary rate (highest rate being 39.6 percent) on the remaining 70 percent of income. When combined with the NIIT, active investors would essentially pay a rate up to 39.02 percent.[3]

The Senate came at the issue from another direction. That is, the Senate bill does not have a special tax rate for pass-through earnings, but instead would permit a deduction of up to 23 percent of the amount of a taxpayer's trade or business income that is passed through from a partnership, S corporation or sole proprietorship.[4]

The deduction is limited to 50 percent of the taxpayer's share of W-2 wages paid by the company and attributable to a trade or business unless an exception to the W-2 wage limitation applies. In circumstances where the W-2 limitation does not apply, this deduction effectively taxes flow through earnings at a rate of 33.5 percent.[5]

The main issue for energy companies will be the applicability of this W-2 limitation. Many labor intensive activities (such as drilling) are performed by independent contractors and not W-2 employees of the owner of the minerals. MLPs have historically relied on employees of a corporate subsidiary or the corporate sponsor (rather than their own employees) to operate their assets. To reflect this reality, Senator Cornyn of Texas was successful in adding an amendment that exempts oil and gas MLP income from this burdensome W-2 limitation.

In an industry like the oil and gas space, where there are many competing oilfield service providers, the W-2 limitation, where applicable, effectively provides a tax incentive for vertical integration — that is, to consolidate the companies that typically provides services to the minerals owners as independent contractors into W-2 wage earners employed by the integrated company.

Note that both the House and Senate bills impose ordinary rates on the traditional service industries, such as banking, law and accounting (39.6 percent in the House bill, 38.5 percent in the Senate bill, with the NIIT on top of that in each case). Notably, the Senate bill would permit service providers in these fields to benefit from the pass-through income deduction to the extent their income is not greater than $500,000 in the case of married taxpayers filing jointly, with the benefit phasing out for such taxpayers with income between $500,000 and $600,000.[6]

Build Now, Pay Taxes Later

Both the House and Senate bills contain very favorable incentives to invest in property, plant and equipment from the period beginning Sept. 27, 2017 to Dec. 31, 2022. Both bills achieve this by simply doubling the existing 50 percent "bonus depreciation" deduction to 100 percent for property with a depreciable recovery life of not more than 20 years.

As is the case in the existing bonus depreciation regime, the immediate expensing of these capital expenditures results in a deferral (and not elimination) of tax; the day of reckoning will come upon the ultimate taxable disposition of the property.

In the oil and gas space, upstream exploration and production players have long enjoyed full expensing for intangible drilling costs (IDCs). The new proposal would allow 100 percent expensing for capitalized equipment expenses in the upstream space. For midstream and downstream sectors, the ability to deduct the costs of pipelines, terminals, processing facilities and refinery equipment is game-changing.

The Pending AMT Fight

The House bill repeals the alternative minimum tax (AMT), but the Senate bill only increased the individual exemption for the 2018-2025 tax years. Because oil and gas companies utilize a number of deductions that are tax preferences under the AMT like IDCs, percentage depletion and accelerated depreciation, the repeal of the AMT proposed by the House would be a welcome change for many oil and gas upstream, midstream and downstream enterprises.

End of Year Tax Planning Opportunities

Net operating losses and other deferred tax assets become less valuable following any reduction in tax rates.[7] In addition, depending on how much time will be left in the year following the House and Senate agreeing on a proposal, oil and gas companies with usable tax attributes (and there are many) would have a strong tax incentive to dispose of low basis assets before their tax assets become less valuable.

Taxpayers without tax assets, on the other hand, would be incentivized to delay taxable dispositions of low basis assets until the lower rates take effect. In the Senate Bill, the corporate rate reduction waits until 2019, so all of 2018 could be used under that proposal to maximize tax attribute value by accelerating income.

Correction: In a previous version of this article, the effective tax rate on flow through earnings under the Senate's tax bill was erroneously calculated as 32.57 percent, instead of 33.5 percent. The errors have been corrected.

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[1] Current law applies a 35 percent corporate level tax rate on income above $10,000,000. After payment of $35 of corporate taxes on $100 of earnings, a corporation will have $65 of remaining cash that it can pay as a dividend to its shareholders, who will recognize an additional $15.47 of income taxes. (20.0% + 3.8%) × $65 = $15.47. Combined with the corporate taxes of $35, the government receives $50.47 of every $100 of corporate earnings. Under the House and Senate Bills, the amount of these taxes is reduced significantly. $20 of corporate taxes are collected initially, and with $80 distributed, there is an additional $19.04 of shareholder level taxes. (20.0% + 3.8%) × $80 = $19.04. Combined with the corporate taxes of $20, the government only receives $39.04 of every $100 of corporate earnings.

[2] Where the active investor has more than 30 percent of the capital in the company, a larger share of income is taxed at the lower 25 percent rate.

[3] $(30\% \times 25.0\% + 70\% \times 39.6\%) + 3.8\% = 39.02\%$

[4] This deduction also applies in the case of certain REIT and cooperative dividend income.

[5] As an example, assume $100 of earnings, reduced by a $23.00 deduction, yielding $77.00 of net taxable income, multiplied by the 38.5 percent tax rate and adding $3.80 of NIIT. The result is about $33.50 of tax.

[6] In the case of a single return, the income thresholds are 50 percent of those that apply in the case of the joint return.

[7] This devaluation of tax attributes is further aggravated by both the House and Senate proposals to eliminate the ability to carryback NOLs or utilize NOLs to reduce more than 90 percent of a taxpayer's income (or 80 percent in the case of taxable periods beginning 2023 under the Senate proposal).