



Tax Reform - KPMG Report on New Tax Law

Energy and Natural Resources - Key Provisions

January 31, 2018



Highlights of tax provisions

New tax law relating to energy and natural resources

KPMG has prepared a report on P.L. 115-97 (the Act) that summarizes and makes observations about the revenue provisions. For ease of reference, we have compiled our summaries and observations relating to certain specific industries and topics in separate booklets. This booklet highlights revenue provisions relating to Energy and Natural Resources. Other booklets address other topics.

Background

The centerpiece of the Act is the permanent reduction in the corporate income tax rate from 35% to 21%. The rate reduction generally took effect on January 1, 2018. The Act also repeals the corporate alternative minimum tax (AMT).

The full list of other changes for businesses is extensive, including both additional tax benefits and offsetting tax increases. Some highlights are listed below.

The Act temporarily introduces expensing as the principal capital cost recovery regime, increasing the section 168(k) first-year “bonus” depreciation deduction to 100% and allowing taxpayers to write off immediately the cost of acquisitions of plant and equipment. This expensing regime goes further than prior law bonus depreciation by applying to both new and used property. The 100% bonus depreciation rule applies through 2022, and then will ratably phase down over the succeeding five years.



The Act also adopts a provision that permits certain non-corporate owners (i.e., owners who are individuals, trusts, or estates) of certain partnerships, S corporations, and sole proprietorships to claim a 20% deduction against qualifying business income. The Act includes numerous limitations on the income eligible for the deduction, with the apparent goal of treating compensation for services as ordinary income that is not eligible for the special deduction. Importantly, the deduction against qualifying income will expire for tax years beginning after December 31, 2025.

To partially offset the costs of the business tax benefits, the Act repeals or modifies a number of existing provisions in the tax law. For example, the Act:

- Repeals the section 199 domestic manufacturing deduction (beginning in 2018)
- Limits the deductibility of net business interest expense to 30% of adjusted taxable income. This provision starts with a broader definition of adjusted taxable income, but significantly narrows that definition beginning in 2022
- Limits the carryover of net operating losses to 80% of taxable income and eliminates the carryback (with special rules for certain insurance and farming businesses)
- Narrows the scope of the rules relating to contributions to capital (without repealing section 118 for corporations)
- Modifies the deductibility of business entertainment expenses
- Provides significant changes for taxation of the insurance industry
- Requires certain research or experimental (R&E) expenditures to be capitalized beginning in 2022

For individuals, the Act retains seven tax brackets but modifies the “breakpoints” for the brackets and reduces temporarily the rate for the top bracket to 37%. The temporary new brackets are 10%, 12%, 22%, 24%, 32%, 35%, and 37%. The top rate applies to single filers with income over \$500,000 and married joint filers with income over \$600,000. The standard deduction is temporarily increased to \$24,000 for joint filers and \$12,000 for individual filers, with these deductions indexed annually. At the same time, the deduction for personal exemptions is suspended, while the child tax credit is enhanced and the phase-out thresholds are substantially increased.



Energy provisions

For natural resources, in general, the special industry rules continue to apply.

Fossil fuel provisions

For natural resources, in general, the special rules continue to apply:

1. Oil and gas geological and geophysical costs (section 167(h), qualified tertiary injectant expenses (section 193), intangible drilling costs (section 263(c), as limited for integrated corporations by section 291(b), and section 263(i)), depletion (sections 611, 612 and 613A), ordinary income recapture potential (section 1254)
2. Mining exploration and development costs (sections 616 and 617, as limited for corporations by 291(b)), depletion (sections 611, 612 and 613 as limited for corporations by 291(a)(2) for percentage depletion in excess of tax basis on iron ore and coal), the disposal of coal or domestic iron ore with a retained economic interest as capital gain (section 631(c)), and ordinary income recapture potential (section 1254)
3. Timber reimbursements of certain government reforestation costs (section 126(a)(8) and (9)) and amortization of certain reforestation expenditures (section 194), election to consider cutting timber or the disposal of timber with a retained economic interest as a sale (section 631(a) and (b)).



KPMG observation



The Act did not repeal either the section 43 enhanced oil recovery credit or the section 45I credit for producing oil and gas from marginal wells for taxable years beginning after December 31, 2017. However, section 199 is repealed for tax years beginning after December 31, 2017.

In addition, a new section 199A provides a 20% deduction for qualified business income for certain noncorporate taxpayers (including income from publicly traded partnerships) for tax years beginning after December 31, 2017. For example, an individual oil and gas working interest owner could qualify for the section 199A deduction, and pay the section 1401 self-employment tax of 3.8% (deductible for income taxes) instead of the section 1411 3.8%-net investment income tax.

The AMT is repealed for corporations for tax years beginning after December 31, 2017. Taxpayers other than corporations continue to be subject to the AMT and may need to make adjustments for mine exploration and development costs (section 56(a)(2)(A)); mine depletion (sections 56(g)(F)(i) and 57(a)(1)); and the oil and gas and geothermal intangible drilling and development costs preference (section 57(a)(2)).

While not specifically a fossil fuel provision, the limitation on like-kind exchanges to real property might not have a substantial negative impact on natural resource conservation measures, often required by local law. Natural resource property (other than timber) is defined in section 614. Specifically, section 614(b)(3) treats properties participating in a unitization or pooling agreement as a single property. Unitizations and poolings are conservation techniques that prevent producers who own tracts of land over a larger pool of minerals from rushing to produce reserves (law of capture) from that pool of minerals and often reducing the total recovery of reserves.

For federal income tax purposes, the term “unitization or pooling agreement” means an agreement under which two or more persons owning operating mineral interests agree to have the interests operated on a unified basis, and the owners also agree to share in production on a stipulated percentage or fractional basis regardless of which interest or interests the oil or gas is produced from. In addition, when one person owns all of the operating mineral interests in several leases, an agreement with its several royalty owners to determine the royalties payable to each on a stipulated percentage basis (regardless of which lease(s) oil or gas is produced) is also considered to be a unitization or pooling agreement. No formal cross-conveyance of properties is necessary.

Rev. Rul. 68-186, 1968-1 C.B. 354 noted that:

The position that a unitization effects an exchange was confirmed by the amendment to section 614 of the Internal Revenue Code of 1954 made by the Revenue Act of 1964. Section 614(b)(3) of the Code; H. Rept. No. 749, C.B. 1964-1 (Part 2), 125, at 216; S. Rept. No. 830, C.B. 1964-1 (Part 2), 505, at 622.

The exchange of working interests qualifies, as does the exchange of equipment, under section 1031 of the Code as property held for productive use in a trade or business or for investment which is exchanged solely for property of a like kind to be held for use in a trade or business or for investment.

On some federal offshore properties, the producers cannot enter a unit without first drilling a producing well. This causes a series of unit enlargements (e.g., up to 12 enlargements of the same unit), each of which is treated as a section 1031 exchange. Treating unitizations and poolings (including communalizations formed pursuant to 30 U.S.C.



§ 226(m); 43 C.F.R. § 3105.2-2) as taxable events would have run counter to their conservation nature causing substantial unwarranted tax bills.

Section 1201(b) continues to provide a 23.8-percent alternative tax rate for corporations on the portion of a corporation’s taxable income that consists of qualified timber gain (or, if less, the net capital gain) for a taxable year. Qualified timber gain means the net gain described in section 631(a) and (b) for the taxable year, determined by taking into account only trees held more than 15 years.

Additional natural resource related issues

New section 1061 concerning partnership interests held in connection with the performance of services provides a 3-year holding period for section 1222 capital gains treatment for defined applicable trade or business for investing in or developing specified assets. As natural resource development and production of operating interests is not listed as a specified asset and the sale of operating mineral interests would produce 1231 and 1254 gains, not section 1222 gains, this provision would likely not apply to operating mineral interests.

Section 59(e) has not been repealed, however section 59(f), which coordinated section 59 with section 291(b), was repealed. (Section 59(f) requires a 30% capitalization and 60-month amortization of mine exploration and development costs incurred by corporations and intangible drilling and development costs (IDC) incurred by integrated oil and gas corporations.) It appears that post 2017, corporations may still be able to make section 59(e) elections to capitalize some or all of their mine exploration and development costs over a 10-year period and IDC over a 60-month period. [Note that the Joint Committee on Taxation staff might publish a “Blue Book” on the Act that may provide additional guidance.] Corporations may wish to make post 2017 section 59(e) elections to add back amortization for section 163(j) (limitation on deduction for interest).

New section 250 generally provides domestic corporations with reduced rates of U.S. tax on their foreign-derived intangible income (FDII) from U.S. export sales and foreign services as well new section 951A global intangible low-taxed income (GILTI) inclusions. For taxable years beginning after December 31, 2017, and before January 1, 2026, the effective tax rate on FDII is 13.125% and the effective U.S. tax rate on GILTI inclusions is 10.5%, when the full deduction is allowed. For taxable years beginning after December 31, 2025, the effective tax rate on FDII is 16.4062% and the effective U.S. tax rate on GILTI is 13.125%, when the full deduction is allowed. Domestic oil and gas extraction income of a corporation is not eligible for the FDII deduction but conversely the depreciable extraction assets would not be included in determining the deemed tangible income return, which would reduce FDII. Similarly, in determining a CFC’s tested income for GILTI purposes, foreign oil and gas extraction income and its related deductions are excluded. However, oil related income and its related deductions are included in both the FDII and GILTI calculations. The exclusion of income from GILTI is favorable because the excluded income is generally exempt from US tax, while the exclusion of income from FDII is unfavorable because the amounts excluded from FDII are effectively subject to US tax at the full 21% corporate rate.



Determining oil and gas extraction income and oil related income for FDII and GILTI

Oil and gas extraction income (OGEI) is, in general, the gross depletable income from the oil and gas property under section 613(a) plus the sale or exchange of assets used in the trade or business, less depletion, and can be derived by using the residual (rate of return) method by first calculating oil related income (ORI) and subtracting ORI from the total income from the production and sale of the oil or gas product. A taxpayer can determine ORI by applying an assumed after-tax rate of return to the cost of its fixed ORI assets. Because income from the production and sale of oil and gas product is equal to the sum of OGEI and ORI, once the total income and ORI are established, OGEI can then be determined by subtracting ORI from total income.

Classification of Assets as OGEI and ORI Assets

Examples of OGEI assets include:

Wells, wellheads, and pumping equipment.

Flowlines, headers, and manifolds.

Desilters and other vessels to remove solid contaminants.

In the case of oil production, slug catchers, separators, treaters, emulsion breakers, and stock tanks needed to obtain marketable crude oil.

In the case of gas production, primary separation and dehydration equipment needed to arrive at a gaseous stream in which natural gas, condensate, and other hydrocarbons can be recovered. [Note sour gas may require additional processing -see TAM 7908005.]

Equipment needed to produce, transport, and inject fluids and gasses into the wells or reservoir.

Lines that interconnect above-listed equipment.

Instrumentation, metering, safety, control, utility, power and other infrastructure-type equipment to provide for operation of the above.

Structures to physically support the above equipment, such as offshore platforms.

Examples of ORI assets include:

In the case of gas production, lease equipment beyond the primary separator and dehydrator to recover natural gas, condensate, and other hydrocarbons.

Lines that carry natural gas beyond the primary separator and dehydration equipment and towards its sales point, as well as, compressors needed to transport natural gas through these lines.

Lines that carry marketable crude oil from the premises, as well as, pumps needed to transport crude oil through these lines.

Assets used to process crude oil and natural gas.





Contact a KPMG professional:

Mike Terracina
National Tax Leader Partner
Oil & Gas
T: 713-319-2293
E: mterracina@kpmg.com

Robert Swiech
Washington National Tax
Tax Director
Tax Credit and Energy Advisory Services
T: 713-319-3257
E: rswiech@kpmg.com

Jaime Park
Washington National Tax
Tax Director
Tax Credit and Energy Advisory
Services
T: 202-533-5711
E: jaimepark@kpmg.com

John Gimigliano
Washington National Tax
Principal in Charge
Federal Legislative and Regulatory
Services
T: 202-533-4022
E: jgimigliano@kpmg.com

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