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The U.S. Tax Reform and the Energy Sector

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President Donald Trump and Republican Congressional leaders have promised a major reform to the U.S. tax code in 2017. This reform, if anything close to these promises, will have significant implications for the energy industry in the U.S., and worldwide. Little of what will ultimately be included in this reform bill is clear at this point. In general, though, the goal of the White House and Congressional Republicans is to make investment, and production in the U.S. more attractive by reducing the associated U.S. tax burden.

This bill will likely affect any individual or company — U.S. or foreign-based — with business in the U.S., and will likely completely revamp the nation's current tax code as it applies to multinational corporations. The road to the enactment of this legislation will be far from smooth — there will be turf battles and disagreements, not only between the parties, but also between industries and interests — and it will take time. Given the hurdles the bill will face, moving a bill through the legislative process to enactment will almost certainly take most of 2017, if not longer. Much of this reform will be positive for businesses and individuals alike, but there will be trade-offs as well that may divide industries or even different companies in the same industries.

The debate in Washington, D.C. so far this year, has centered on the Tax Reform Blueprint proposal issued by Speaker of the House Paul Ryan, and House Ways and Means Chairman Kevin Brady in early 2016. The Blueprint was the product of extensive work by a Republican Congressional task force, and represents a major re-write of the tax code; far beyond changes in rates. The Trump tax reform plan issued during the President's political campaign is similar in many respects to the Blueprint, but is lacking in detail. It is, currently unclear whether President Trump will support the most controversial element of the Ryan/Brady Blueprint: the border adjustment mechanism. President Trump has recently promised to release a more detailed tax plan in the upcoming weeks, which is reportedly being developed chiefly by the Director of Trump's National Economic Council, Gary Cohn, and newly installed Secretary of the Treasury Steven Mnuchin. At the same time, Senate Finance Committee Chairman Orrin Hatch has announced the development of his own tax reform plan, and has stated he will seek the support of Senate Democrats for this bill.

If, as many expect, U.S. tax reform becomes a Republican-only effort, the bill could still move through Congress via the reconciliation process under the Budget Act of 1974, which would allow Republicans to pass a bill with only 51 votes in the Senate, avoiding risk of a Democrat filibuster, which would otherwise require 60 votes to overcome. Moving a bill through reconciliation, though, will make the process much more complicated. This would require that the House and Senate pass a budget resolution, and that the Senate comply with the Byrd rule, requiring 60 votes to overcome a point of order if the bill results in any revenue loss after the years included in the Budget Resolution. In addition, Republicans may have trouble getting sufficient support even within their own caucus, over issues such as concern over the rising U.S. national debt and the potential for tax reform to increase this debt. Although President Trump, during his campaign, did not express

much concern about the U.S. debt, the issue remains a concern among many Republican deficit hawks.

The following are some of the primary elements of the Trump and Ryan/Brady Blueprint tax reform proposals. Neither President Trump nor Ryan/Brady have yet released legislative language for their proposals, though the Ryan/Brady Blueprint is far more detailed than the current Trump proposal.

Ryan/Brady Blueprint:

- 20 percent corporate tax rate
- 25 percent rate for pass-through business income
- A cash-flow "destination based" consumption tax structure for business
  - Full expensing for capital investments
  - No deductibility of interest expense beyond interest income
  - Territorial tax system with one-time tax on accumulated foreign E&P (8.75 percent cash/3.75 percent non-cash rates)
  - Border adjustment mechanism: tax imports and deduct exports
- Industry-specific tax preferences and other unspecified tax preferences (presumably including energy-related tax incentives) would be repealed
- Transition rules – Blueprint: "The Committee on Ways and Means will craft clear rules to serve as an appropriate bridge from the current tax system to the new system, with particular attention given to comments received from stakeholders on this important matter"
- Individual income tax rates lowered to 12 percent, 25 percent, 33 percent
- Individual investment income (taxed at half of earned income rates)

Trump Tax Reform Plan:

- 15 percent corporate tax rate
- 15 percent rate for pass-through business income
  - Manufacturers have option to fully expense capital investments if they opt to waive deduction of interest expense
  - Campaign expressed support for a one-time tax on accumulated foreign E&P, but the plan appears to retain the U.S. extraterritorial system
  - Repeal most corporate tax expenditures, except R&D credit
- Individual tax rates lowered to 12 percent, 25 percent, 33 percent
- Caps itemized deductions at U.S.$100k, U.S.$200k

Significance for the energy industry

Full expensing of capital expenditures and a reduction in the U.S. corporate tax rate from the current 35 percent to 20 percent or 15 percent will on balance significantly reduce the tax cost of doing business in the U.S. On the other hand, the loss of the deduction for net interest expense – proposed in the Blueprint— will raise the cost of debt in the U.S.

The ability for U.S.-based corporations to repatriate profits from foreign subsidiaries on a tax free basis (after paying a one-time tax on all accumulated earnings and profits of foreign subsidiaries) should significantly increase the incentive for these companies to repatriate cash and use it to make U.S. investments (or perhaps to pay down debt or pay dividends).

The Blueprint's border adjustment mechanism (also known as a border adjustment tax, or BAT) would have significant implications for the energy industry. Under this proposal, businesses with U.S. income would not be able to deduct imports (including any property, services, or intangibles) as part of their cost of goods sold. Conversely, all export income for U.S. business taxpayers would be untaxed. This would mean, for example, that U.S. oil refiners using imported crude oil would lose their deduction for the cost of the imported crude; and U.S. exporters of liquid natural gas would deduct the cost of domestic-sourced natural gas, but would not have to pay tax on export income. Businesses with U.S. sales that rely heavily on imports would have significantly higher U.S. tax liability; the opposite would be true for U.S. businesses with significant net export income. U.S.-based multinationals that have established foreign subsidiaries and tax structures in low-tax jurisdictions to sell goods or services abroad might find greater tax savings by locating in the U.S., since export income would be free from U.S. tax. Any tax advantage of locating operations or assets abroad and importing goods or services into the U.S. could also disappear, since imports would not be deductible to U.S. business taxpayers. Many economists predict that the enactment of a U.S. border adjustment tax would result in a fairly immediate increase (by as much as 25 percent) in the value of the U.S. dollar against non-U.S. currencies to offset the increased cost of U.S. imports. This, if true, should result in a corresponding reduction in the U.S.-denominated price of commodities like oil and gas. It would also, of course, mean a significant reduction in the U.S. dollar value of assets held in non-U.S. currencies. Both the Blueprint and the Trump plan call for the repeal of industry specific incentives (except the R&D credit). It is our expectation that incentives like the wind and solar tax credits, for example, will at best be allowed to phase out under their current expiration schedule under US law. In addition, some longstanding production preferences for the fossil fuel industry could come under scrutiny.

Prospects for U.S. tax reform

We believe it is likely that a major tax reform bill will be enacted in late 2017 or early 2018. The ultimately enacted legislation, however, is likely to look very different from the current Blueprint or Trump plans. Prospects for the House Blueprint's border adjustment proposal are uncertain at best. There is growing skepticism of the proposal, including some outright opposition, among Republicans and Democrats alike in the U.S. Senate. Also, in recent weeks, there has been an intensifying lobbying effort in opposition to the border adjustment tax, or BAT, in particular by retail business interests that sell mostly imported goods, as well as among oil refiners and other U.S. businesses that rely on imported goods, services, and intangibles. If President Trump does not ultimately come out in full support of the BAT proposal, it will almost certainly be dead.

Although full details on the BAT proposal have not yet been released by its authors, reports suggest a structure that may not withstand World Trade Organization (WTO) scrutiny, since the BAT would adjust a direct, rather than indirect tax, and the resulting structure could not be said to be economically equivalent to European style value-added taxes that are allowed by the WTO. If the BAT is included in the U.S. tax reform bill that is ultimately enacted, it is a near certainty that it would be challenged before the WTO, which could very likely result in retaliatory tariffs and, possibly, a full trade war among many WTO members and the U.S. Whether or not President Trump proposes a BAT in similar form, however, it is very possible that he will propose some kind of structure that would impose taxes on at least some imported goods, which itself would be likely to face intense WTO scrutiny.

In any case, the global energy industry has much at stake as U.S. tax reform continues to develop, and we will be closely engaged in this process.

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