

2017

**Federal Tax Reform Overview:
Focus on Energy Sector**



Building a better
working world

Executive Summary

- ▶ In 2017 the GOP will control the White House, Senate and House of Representatives
- ▶ Congressional budget reconciliation processes exist that will allow Republicans, if necessary, to avoid filibusters and pass major bills without obtaining Democrats' votes
- ▶ Comprehensive tax reform is among top GOP priorities for 2017 and extremely likely to move forward in 2017

2016 elections overview

Presidential		
Electoral votes	306 Trump	232 Clinton
Popular vote	47% Trump 62.3 million	48% Clinton 64.4 million

House, 114th Congress	House, 115th Congress	
246/186 w/3 vacancies	239/194 w/2 undecided: Louisiana runoff on December 10	
Speaker Ryan (R-WI) Majority Leader: McCarthy (R-CA) Democratic leader: Pelosi (D-CA)	Speaker Ryan (R-WI) Majority Leader: McCarthy (R-CA) Whip: Scalise (R-LA) Conf. Chair: McMorris Rodgers (R-WA)	Democratic leader: Pelosi (D-CA) Democratic whip: Hoyer (D-MD) Asst. Dem. leader: Clyburn (D-SC)

Senate, 114th Congress	Senate, 115th Congress	
54/46 w/2 Independents	52/48 w/2 Independents,	
Majority Leader: McConnell (R-KY) Democratic Leader: Reid (D-NV) Majority Whip: Cornyn (R-TX)	Majority Leader: McConnell (R-KY) Majority Whip: Cornyn (R-TX) Conference Chair: Thune (R-SD) Policy Cte. Chair: Barasso (R-WY) Conf. Vice Chair: Blunt (R-MO)	Democratic Leader: Schumer (D-NY) Minority Whip: Durbin (D-IL) Asst. Dem. Leader: Murray (D-WA) Chair of Dem. Policy and Comms. Committee: Stabenow (D-MI) Chair of Outreach: Sanders (I-VT)

Trump cabinet picks

Department	Nominee
Treasury	Steven Mnuchin, financier
Health & Human Services	Rep. Tom Price (R-GA), current House Budget Committee Chair, Ways & Means member
CMS	Seema Verma, Indiana health policy consultant
Commerce	Wilbur Ross, investor
Transportation	Elaine Chao, former Labor Secretary
Labor	Andy Puzder, CKE Restaurants CEO
Attorney General	Senator Jeff Sessions (R-AL)
Education	Betsy DeVos, school choice activist
HUD	Ben Carson, surgeon
CIA	Rep. Mike Pompeo (R-KS)
UN Ambassador	Nikki Haley, South Carolina Governor

House Ways and Means Committee

Republicans (24)

- ▶ Kevin Brady (R-TX), Chairman
- ▶ Sam Johnson (R-TX)
- ▶ Devin Nunes (R-CA)
- ▶ Pat Tiberi (R-OH)
- ▶ Dave Reichert (R-WA)
- ▶ ~~Chas. Boustany, Jr. (R-LA)~~
- ▶ Peter Roskam (R-IL)
- ▶ ~~Tom Price (R-GA) *tapped as HHS Secretary*~~
- ▶ Vern Buchanan (R-FL)
- ▶ Adrian Smith (R-NE)
- ▶ Lynn Jenkins (R-KS)
- ▶ Erik Paulsen (R-MN)

- ▶ Kenny Marchant (R-TX)
- ▶ Diane Black (R-TN)
- ▶ Tom Reed (R-NY)
- ▶ Mike Kelly (R-PA)
- ▶ ~~Todd Young (R-IN)~~
- ▶ Jim Renacci (R-OH)
- ▶ Kristi Noem (R-SD) *running for governor*
- ▶ Pat Meehan (R-PA)
- ▶ George Holding (R-NC)
- ▶ Jason Smith (R-MO)
- ▶ ~~Robert Dold (R-IL)~~
- ▶ Tom Rice (R-SC)

Democrats (15)

- ▶ Richard Neal (D-MA) *ranking member*
- ▶ Sander Levin (D-MI)
- ▶ ~~Charles Rangel (D-NY)~~
- ▶ ~~Jim McDermott (D-WA)~~
- ▶ John Lewis (D-GA)
- ▶ ~~Xavier Becerra (D-CA) *to become California AG*~~
- ▶ Lloyd Doggett (D-TX)
- ▶ Mike Thompson (D-CA)
- ▶ John Larson (D-CT)
- ▶ Earl Blumenauer (D-OR)
- ▶ Ron Kind (D-WI)
- ▶ Bill Pascrell (D-NJ)
- ▶ Joseph Crowley (D-NY)
- ▶ Danny Davis (D-IL)
- ▶ Linda Sanchez (D-CA)

Senate Finance Committee

Republicans (14)

- ▶ Chairman Orrin Hatch (R-UT) 2018
- ▶ Chuck Grassley (R-IA) 2016
- ▶ Mike Crapo (R-ID) 2016
- ▶ Pat Roberts (R-KS)
- ▶ Mike Enzi (R-WY)
- ▶ John Cornyn (R-TX)
- ▶ John Thune (R-SD) 2016
- ▶ Richard Burr (R-NC) 2016
- ▶ Johnny Isakson (R-GA) 2016
- ▶ Rob Portman (R-OH) 2016
- ▶ Pat Toomey (R-PA) 2016
- ▶ ~~Dan Coats (R-IN)~~
- ▶ Dean Heller (R-NV) 2018
- ▶ Tim Scott (R-SC) 2016

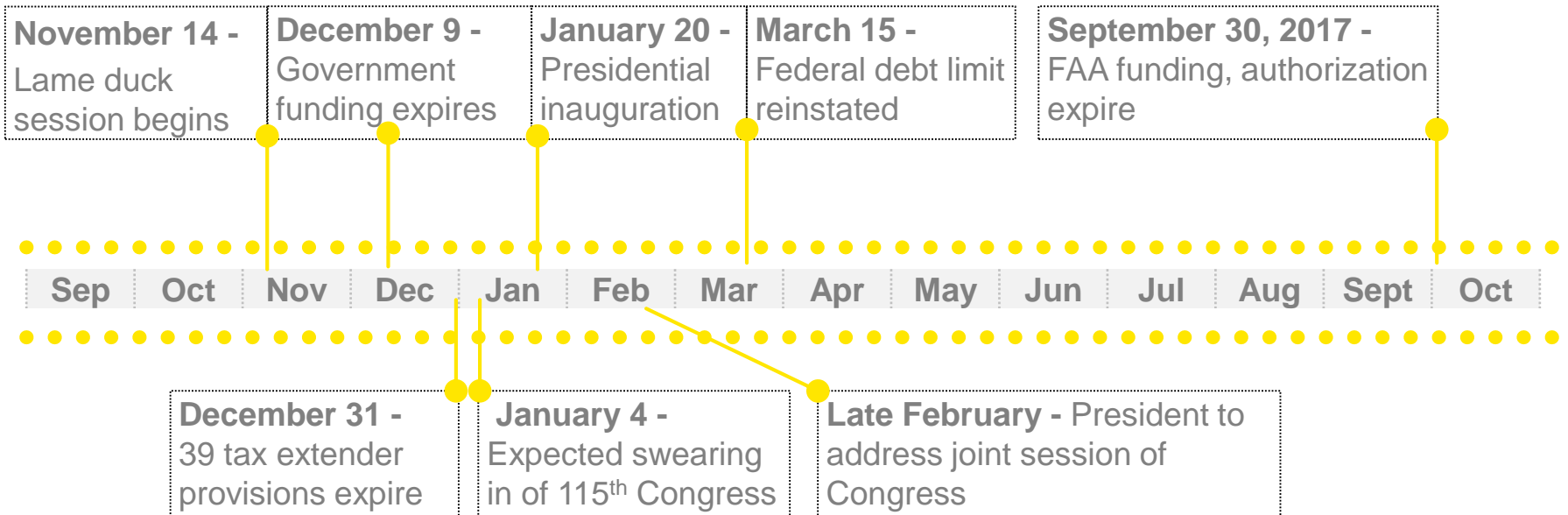
Democrats (12)

- ▶ Ron Wyden (D-OR) 2016
- ▶ Chuck Schumer (D-NY) 2016
- ▶ Debbie Stabenow (D-MI) 2018
- ▶ Maria Cantwell (D-WA) 2018
- ▶ Bill Nelson (D-FL) 2018
- ▶ Robert Menendez (D-NJ) 2018
- ▶ Thomas Carper (D-DE) 2018
- ▶ Ben Cardin (D-MD) 2018
- ▶ Sherrod Brown (D-OH) 2018
- ▶ Michael Bennet (D-CO) 2016
- ▶ Bob Casey (D-PA) 2018
- ▶ Mark Warner (D-VA)

2016 = up in the current election

2018 = up for re-election in 2018

Washington timeline, agenda 2016-2017



Must-do items for 2017

- ▶ Government funding: budget and appropriations for FY 2018
- ▶ Federal debt limit: current suspension ends March 15, 2017
- ▶ Supreme Court nomination and other Administration appointments
- ▶ Federal Aviation Administration reauthorization
- ▶ Children's Health Insurance Program

2018 Senate elections

Seats up for re-election: 23 Democratic plus 2 Independents, 8 Republican

Democrats		Republicans
Tammy Baldwin (D-WI) T	Amy Klobuchar (D-MN)	John Barasso (R-WY)
Sherrod Brown (D-OH) T	Joe Manchin (D-WV) T	Bob Corker (R-TN)
Maria Cantwell (D-WA)	Claire McCaskill (D-MO) T	Ted Cruz (R-TX)
Ben Cardin (D-MD)	Robert Menendez (D-NJ)	Deb Fischer (R-NE)
Tom Carper (D-DE)	Chris Murphy (D-CT)	Jeff Flake (R-AZ)
Bob Casey (D-PA) T	Bill Nelson (D-FL) T	Orrin Hatch (R-UT)
Joe Donnelly (D-IN) T	Debbie Stabenow (D-MI) T	Dean Heller (R-NV)
Dianne Feinstein (D-CA)	Jon Tester (D-MT) T	Roger Wicker (R-MS)
Kirsten Gillibrand (D-NY)	Elizabeth Warren (D-MA)	
Martin Heinrich (D-NM)	Sheldon Whitehouse (D-RI)	
Heidi Heitkamp (D-ND) T		
Mazie Hirono (D-HI)	+2 Independents that caucus with Democrats:	
Tim Kaine (D-VA)	Angus King (I-ME)	
	Bernie Sanders (I-VT)	

T = Running in state won by Donald Trump in 2016

Trump/Republican priorities, 2017

Tax reform



- ▶ Trump, House GOP have similar proposals on rates
- ▶ Different approaches to international taxation
- ▶ All-GOP control opens door for comprehensive tax reform

ACA repeal



- ▶ Reconciliation instructions likely necessary for Senate
- ▶ Ryan 'replace' plan retains some elements of ACA
- ▶ Trump could strike some parts of ACA without Congress

Infrastructure



- ▶ Trump wants public-private partnerships, private investments
- ▶ Election outcome takes focus off repatriation as funding
- ▶ Democrats also interested in increased investment

Regulatory reform



- ▶ Trump could roll back some Obama regulations
- ▶ Fiduciary rule, Dodd-Frank elements among targets
- ▶ House GOP Better Way effort also targeted regulatory reform

Energy



- ▶ Trump to cancel Obama energy rules, e.g. on power plants
- ▶ Favorable treatment expected for coal, oil, natural gas
- ▶ Trump denies climate change, wants US out of Paris deal

“Contract with the American Voter” first 100 days priorities announced by Trump 10/22/16

- ▶ **Middle Class Tax Relief And Simplification Act** : tax reform
- ▶ **End The Offshoring Act** : tariffs to discourage corp. relocation
- ▶ **American Energy & Infrastructure Act**: public-private partnerships and private investments = \$1 trillion/10 years for infrastructure
- ▶ **School Choice And Education Opportunity Act**: elementary school choice and college affordability
- ▶ **Repeal and Replace Obamacare Act**: Health Savings Accounts, ability to purchase insurance across state lines
- ▶ **Affordable Childcare and Eldercare Act**: tax deductibility
- ▶ **End Illegal Immigration Act**: wall on Mexican border
- ▶ **Restoring Community Safety Act**: law enforcement resources
- ▶ **Restoring National Security Act**: eliminate defense sequester
- ▶ **Clean up Corruption in Washington Act**: ethics reforms

History shows clear trend of big tax bills in first year of new president's term

Barack Obama Took office January 20, 2009	American Recovery and Reinvestment Act of 2009 Enacted February 17, 2009 <ul style="list-style-type: none">▶ Stimulus legislation, included bonus depreciation
George W. Bush Took office January 20, 2001	Economic Growth and Tax Relief Reconciliation Act of 2001 Enacted June 7, 2001 <ul style="list-style-type: none">▶ The “Bush tax cuts” reduced individual rates, estate tax
Bill Clinton Took office January 20, 1993	Omnibus Budget Reconciliation Act of 1993 Enacted August 10, 1993 <ul style="list-style-type: none">▶ Increased individual, corporate taxes
George H. W. Bush Took office January 20, 1989	Omnibus Budget Reconciliation Act of 1990 Enacted November 5, 1990 <ul style="list-style-type: none">▶ Increased individual taxes despite “no new tax” pledge
Ronald Reagan Took office January 20, 1981	Economic Recovery Tax Act of 1981 Enacted August 13, 1981 <ul style="list-style-type: none">▶ Sharply reduced individual, corporate taxes

Budget reconciliation

- ▶ Republicans don't have filibuster-proof 60 Senate votes
- ▶ Reconciliation allows majority vote (51) for spending, tax, debt limit bills (or combination), under 2-step process
 - 1 House and Senate need to pass a concurrent Budget Resolution with reconciliation instructions
 - = Directions to committees to change spending or revenue numbers
 - 2 Also must pass reconciliation bills that adhere to the instructions
- ▶ Possibility for two sets of reconciliation instructions in 2017
 - 1 January processing of FY 2017 budget
 - ▶ Not considered earlier due to a dispute over discretionary spending
 - ▶ Reconciliation instructions would likely relate to ACA repeal
 - 2 FY 2018 budget would include second set of instructions
 - ▶ Could address issues like replacing the ACA and tax reform

Budget reconciliation limitations

“Byrd Rule” protects views of minority party, prohibits extraneous matter

Six tests for matters to be considered extraneous and thus require 60 Senate votes to waive point of order, applicable to provisions that:

Do not produce a change in outlays or revenues

Produce changes in outlays or revenue which are merely incidental to the non-budgetary components of the provision

Are outside the jurisdiction of the committee that submitted the title or provision for inclusion in the reconciliation measure

Increase outlays or decrease revenue if the provision's title, as a whole, fails to achieve the Senate reporting committee's reconciliation instructions

Increase net outlays or decrease revenue during a fiscal year after the years covered by the reconciliation bill unless the provision's title, as a whole, remains budget neutral

Contain recommendations regarding the OASDI (Social Security) trust funds

These limitations on reconciliation have practical effects, including:

- ▶ The 2001 Bush tax cuts were subject to a sunset after 10 years, and required subsequent legislation to make many provisions permanent
- ▶ The Affordable Care Act cannot be completely repealed under reconciliation

Key considerations for Republican leaders in advancing health care agenda

- ▶ Will Republican leaders repeal and replace the ACA in the same legislation – or will they employ a two-step process?
- ▶ Will Republicans address entitlement reform legislation and ACA repeal in the same legislation?
- ▶ Which parts of the health care agenda will Republicans advance through budgetary processes that do not require bipartisan support?
- ▶ What is the timeline for legislative consideration of key pieces of the health care agenda?
- ▶ Which parts of the health care agenda can be achieved through regulatory action?

Health Reform Task Force Proposal

Caps the employer tax exclusion at a high but undefined level

Encourages adoption of the House-passed 21st Century Cures bill

Proposes medical liability reform

Establishes a Medicare premium support program in 2024

Repeals the Independent Payment Advisory Board (IPAB)

Allows states to transform Medicaid into either a block grant or a “per capita allotment”

Repeals the ACA’s mandates but keeps in place some coverage provisions

Encourages people to have insurance through an advanceable / refundable tax credit (adjusted for age)

Provides \$25 billion in incentives to states to set up high-risk insurance pools

Lifts the ban on physician-owned hospitals

Permits the sale of insurance across state lines and expands access to HSAs

What could tax reform look like?

- ▶ Lower corporate and individual tax rates
- ▶ Lower tax rates on investment income
- ▶ Broader tax base for individual and corporations:
 - ▶ Many deductions, exclusions, and credits will go away
- ▶ New international tax system:
 - ▶ Move from global tax system to territorial system
 - ▶ The US is currently the outlier in the G20 in taxing worldwide income of US companies
 - ▶ Provisions to prevent erosion of the US tax base
- ▶ Transition tax to help pay for infrastructure investments

Tax reform details to be determined include...

1

Will tax reform be revenue neutral?

- Chairman Brady: intended to be break-even with budget, considering economic growth
- Trump campaign tax plan estimated to lose \$4-6 trillion depending on considerations

2

What will be the fate of border adjustability?

- One new concept in House Republican Blueprint on tax reform
- Brady said benefits include: 1) Leveling the playing field for American made products
- 2) Simplifying international tax; and 3) Eliminating incentive to move jobs, HQs overseas

3

Will reform be combined with infrastructure investment?

- Senator Schumer: "That infrastructure bill has to have certain things for us to support it. It can't just be tax credits."
- Brady: Blueprint applies the revenue from "deemed repatriation" toward rate reduction and tax code redesign

4

Will bipartisan support allow reconciliation to be avoided?

- Brady: reconciliation may be the only option for advancing reform, but House GOP to begin by asking Democrats for input
- Partisan reform threatens repeal by other party; reconciliation sunsets after 10 years
- Senator Cornyn: "If you do things purely on the party line, then it's unsustainable."

House Tax Reform Task Force Blueprint: highlights

Corporate tax rate	20%
Business income pass-through tax rate	25%
Taxation of future foreign earnings	Territorial, 100% exemption for dividends paid from foreign subsidiaries
Taxation of accumulated foreign earnings	8.75% for cash/cash equivalents, 3.5% otherwise
Border adjustability	Exports exempt from tax/imports taxed
Cost recovery	100% expensing
Interest expense	No current deduction will be allowed for net interest expense
Corporate tax preferences	Generally eliminated, except for R&D credit/LIFO
Individual tax rates	12%, 25%, 33%
Investment income	50% deduction, basic rates of 6%, 12.5%, and 16.5%
Individual deductions	Eliminated except for mortgage interest, charitable contributions; standard deduction increased
AMT/Estate tax	repealed

Trump tax proposals

Top corporate tax rate	15%
Taxation of small businesses	15% business income tax rate for pass-through entities “that want to retain the profits within the business”
Taxation, future foreign earnings	In 2015, proposed immediate worldwide taxation, repeal of deferral
Taxation, untaxed for. earnings	10%
Cost recovery	Expensing for manufacturers
Interest	Manufacturers who expense lose the deductibility of interest expense
Other business provisions	Most eliminated, except for R&D Credit
Individual tax rates	12%, 25%, 33%
Capital gains	- Existing capital gains rate structure (maximum rate of 20 percent) - 3.8% Net Investment Income Tax (NIIT) repealed
Dividends	Existing rates but NIIT repealed
Carried interest	Ordinary income
Estate tax-now 40%, \$5.43m exempt.	Repealed, but capital gains held until death will be subject to tax, with the first \$10 million tax-free
Dependent care expenses	- Deduction for care expenses for up to four children and elderly dependents, capped at the average cost of care for the state of residence - For those earning \$250,000/year or less individuals, \$500,000 couples
Itemized deductions	Capped at \$100,000 for single filers and \$200,000 for married filers
PEP and Pease	Unspecified “steepening the curve” of PEP and Pease
Personal AMT	Eliminated
Life ins. build-up	Included in income for unspecified high earners

Trump versus House Blueprint: corporate

Tax provision	Trump	House GOP
Top corporate tax rate (now 35%)	15%, corporate AMT eliminated	20%, corporate AMT eliminated
Top pass-through rate (now 39.6%)	15% rate for pass-through entities that retain profits within the business	25%
Taxation of future foreign earnings	In 2015, proposed worldwide system, repeal of deferral; currently unclear	Territorial; 100% exemption for dividends paid from foreign subs.; border adjustment
Mandatory tax, untaxed accumulated foreign earnings	10%	8.75% for cash/cash equivalents, 3.5% otherwise, payable over 8 years
Cost recovery	Expensing for manufacturers	100% expensing: tangible, intangible assets
Interest	Manufacturers electing to expense capital investment lose the deductibility of corporate interest expense	No current deduction will be allowed for net interest expense
Other business provisions	Calls for them to generally be eliminated, except for R&D credit	Calls for them to generally be eliminated, except for R&D credit and LIFO

Trump versus House Blueprint: individual

Tax provision	Trump	House GOP
Individual rates (now 10%, 15%, 25%, 28%, 33%, 35%, 39.6%)	12%, 25%, 33%	12%, 25%, 33%
Capital gains and dividends	Current law (max. rate of 20%), 3.8% Net Investment Income Tax (NIIT) repealed	50% deduction for capital gains, dividends, and interest, leading to basic rates of 6%, 12.5%, and 16.5% (NIIT repeal called for under health care reform plan)
Carried interest	Ordinary income	(Not addressed)
Estate tax (now 40% rate, \$5.45 million exemption)	Repealed, capital gains held until death taxable, first \$10 million tax-free	Repealed
State tax deduction	Cap itemized deductions at	Eliminated
Charitable contribution deduction	\$100,000 for single filers and \$200,000 for couples	Retained, but could be modified
Mortgage Interest deduction		Retained, but could be modified
Personal Exemption Phase-out (PEP), Pease deduction limitation	Unspecified “steepening the curve” of PEP and Pease	(Not addressed)
Life insurance build-up	Included in income for high earners	(Not addressed)

Tightener: Repeal of current deductibility of net interest expense

- ▶ House Tax Reform Blueprint proposes significant change to current law rules on interest expense deductibility
- ▶ Under proposal, interest expenses can only be deducted against interest income
- ▶ Net interest expense can be carried forward indefinitely
- ▶ Designed to avoid tax-based incentives for increasing debt

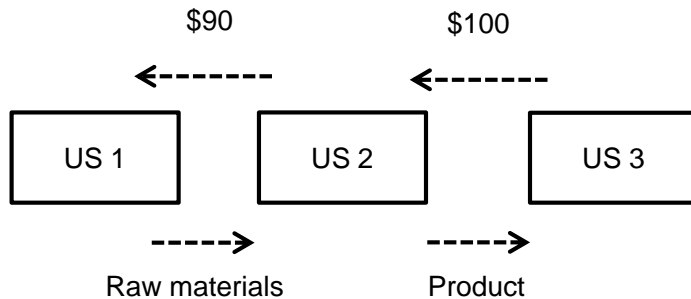
House Blueprint's border adjustments

- ▶ In prior reform efforts, many have thought that border adjustments (BA) might help build support for a VAT because some believe they would help improve the balance of trade
- ▶ The BA's under the House blueprint are viewed in a significantly different light
- ▶ Key questions/issues:
 - ▶ Allowing BAs under a direct tax, as proposed by the House blueprint, differs from the indirect tax form of most other countries' VATs
 - ▶ Are the BAs under the House Blueprint compliant with the World Trade Organization?
 - ▶ Would the BAs have any long-term impact on trade or be offset by changes in countries' real price levels/exchange rates, a view held by economists but met with skepticism by the business community
 - ▶ Would the BA's involve a wealth transfer from the United States to other countries?

Example 1: Import/Export

US-sourced supplies

1. US-sourced supplies remain in US

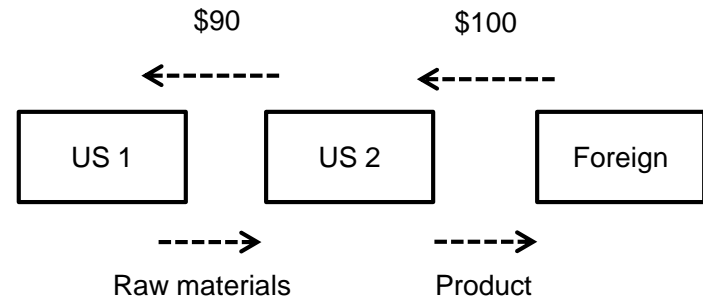


US 2 purchases raw materials from US 1 for \$90.
US 2 sells its product to US 3 for \$100.

Under a cash-flow model, US 2 has \$100 in receipts, and under the consumption-based model, the \$100 is within the US tax base. US 2's expenses are not an import and deductible (labor costs are ignored in this example).

Cash-flow	= \$100
COGS	= \$ 90
<u>Tax base</u>	= \$ 10

2. US-sourced supplies exported



US 2 purchases raw materials from US 1 for \$90.
US 2 sells its product to Foreign for \$100.

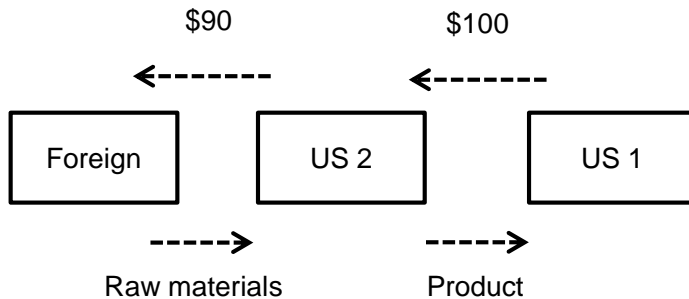
Under a cash-flow model, US 2 has \$100 in receipts, but under the consumption-based model, the \$100 is outside the US tax base. US 2's expenses are not an import and deductible (labor costs are ignored in this example).

Cash-flow	= \$ 0
COGS	= \$90
<u>Tax base</u>	= (\$90)

Example 2: Import/Export

Foreign-sourced supplies

3. Foreign-sourced supplies remain in US

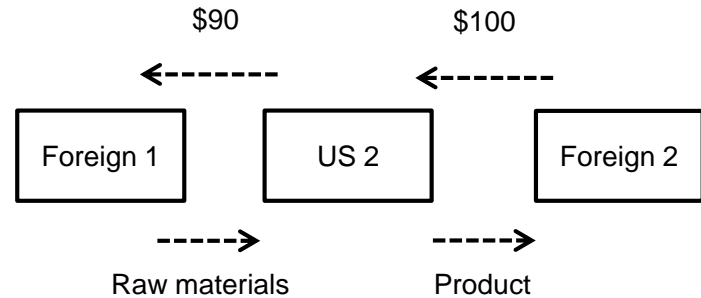


US 2 purchases raw materials from Foreign for \$90. US 2 sells its product to US 1 for \$100.

Under a cash-flow model, US 2 has \$100 in receipts, and under the consumption-based model, the \$100 is within the US tax base. US 2's expenses are an import and not deductible (labor costs are ignored in this example).

Cash-flow	= \$100
<u>COGS</u>	<u>= \$ 0</u>
Tax base	= \$100

4. Foreign-sourced supplies exported



US 2 purchases raw materials from Foreign 1 for \$90. US 2 sells its product to Foreign 2 for \$100.

Under a cash-flow model, US 2 has \$100 in receipts, but under the consumption-based model, the \$100 is outside the US tax base. US 2's expenses are an import and not deductible (labor costs are ignored in this example).

Cash-flow	= \$ 0
<u>COGS</u>	<u>= \$ 0</u>
Tax base	= \$ 0

Potential impact of tax reform on energy companies

- ▶ Lower corporate and individual income tax rates
- ▶ Possible switch to territorial tax system
- ▶ 100% expensing of business investments
- ▶ Repeal of technology-specific credits & deductions like renewable tax credits, percentage depletion, IDCs
- ▶ Border adjustable tax system creates winners & losers

What changed in the final and temporary Section 385 regulations

Apply to interests issued by domestic corporations

Exclude (reserve on) interests issued by foreign corporations

Exclude interests issued by non-captive REITs and RICs

Do not apply to instruments issued within US consolidated group



Bifurcation Rule

Prop. Reg. §1.385-1(d)

- ▶ Eliminated



Documentation Rule

Prop. Reg. §1.385-2

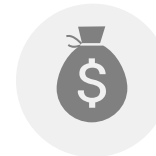
- ▶ Documentation due on return filing date
- ▶ Disregarded entity (DRE) debt recast into equity of regarded owner
- ▶ Exclusion of debt issued by partnership
- ▶ Master agreements blessed
- ▶ Annual debt capacity study allowed
- ▶ Reservation on no affirmative use



Transaction Recharacterization Rule

Prop. Reg. §1.385-3(b)(2)

- ▶ New/expanded exemptions and exclusions (e.g., first \$50 million of recast debt, compensatory stock, post-April 4, 2016 E&P)
- ▶ Exclusion for certain regulated industries



Funding Recharacterization Rule

Prop. Reg. §1.385-3(b)(3)

- ▶ Numerous exemptions and exclusions (e.g., qualified short-term debt instruments, certain acquisitions of subsidiary stock)
- ▶ Exclusion for certain regulated industries

Section 385 regulations: paths to repeal

- ▶ Congressional Review Act
 - ▶ Used for nullifying recently promulgated rules through a joint resolution of Congress
 - ▶ Available for 60 legislative/session days after promulgated
 - ▶ Any rule with a “trigger” date less than 60 days before the adjournment of a Congress gets a new 60 day clock in next session
- ▶ Congress can also act to overturn regulations or executive orders through the normal legislative process
- ▶ New Administration: an agency may rescind an already-published final rule by going through a new Administrative Procedure Act public notice-and-comment process

What you can be doing – how to be at the table and not on the menu

- ▶ Model the possible effects of House GOP blueprint or Trump plan on their business
- ▶ Consult with Washington Council Ernst & Young (WCEY) to create a federal tax reform strategy to support beneficial proposals
- ▶ Meet with Members of Congress, Senators, and Administration officials to educate lawmakers, identify champions.

Questions?

