FILED
September 21, 2018
INDIANA UTILITY
REGULATORY COMMISSION

STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

IN THE MATTER OF THE INDIANA UTILITY REGULATORY COMMISSION'S INVESTIGATION INTO THE IMPACTS OF THE TAX CUTS AND JOBS ACT OF 2017 AND POSSIBLE RATE IMPLICATIONS	)	**CAUSE NO. 45032 S12**
RESPONDENTS: OHIO VALLEY GAS CORPORATION AND OHIO VALLEY GAS, INC.	)	

IURC
RESPONDENT'S
EXHIBIT NO. 2
11-29-18 AT
DATE REPORTER

<u>RESPONDENTS' PHASE TWO REBUTTAL TESTIMONY</u>

Respondents Ohio Valley Gas Corporation and Ohio Valley Gas, Inc. submit the attached rebuttal testimony and exhibits of its witness, Jerry A. Klinker, in response to the testimony of Mark Grosskopf on behalf of the only other party to this subdocket, the Indiana Office of Utility Consumer Counselor, addressing the Phase 2 issues identified by the Indiana Utility Regulatory Commission in this investigation.

Respectfully submitted,

Clayton C. Miller

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ATTORNEY FOR RESPONDENTS OHIO VALLEY GAS CORPORATION AND OHIO VALLEY GAS, INC.

CERTIFICATE OF SERVICE

The undersigned hereby certifies that a copy of the Ohio Valley Gas' Phase 2 direct testimony and exhibits has been served this 21st day September, 2018, by email transmission to the following counsel of record:

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REBUTTAL TESTIMONY OF JERRY A. KLINKER

on behalf of

OHIO VALLEY GAS CORPORATION and OHIO VALLEY GAS, INC.

IURC CAUSE NO. 45032 S12

Q1: Please state your name.

A1: My name is Jerry A. Klinker.

Q2: Are you the same Jerry A. Klinker who also provided direct testimony in this subdocket on behalf of respondents Ohio Valley Gas Corporation and Ohio Valley Gas, Inc. (collectively, "OVG")?

A2: Yes. This subdocket specific to OVG constitutes Phase Two of the Commission-initiated investigation into the impacts of the Tax Cuts and Jobs Act of 2017 ("TCJA"), and my prepared direct testimony and accompanying exhibits were filed in this subdocket on June 19, 2018.

Q3: What is the purpose of your rebuttal testimony?

A3: The purpose of my rebuttal testimony is to respond to the testimony provided by Mr. Mark H. Grosskopf on behalf of the only other party to this subdocket, the Indiana Office of Utility Consumer Counselor ("OUCC").

Q4. Do you agree with some of Mr. Grosskopf's recommendations?

A4. Yes. I'm pleased to report that we are in agreement on multiple material aspects of this subdocket, including:

i. We agree that the amount of OVG's excess accumulated deferred incomes taxes ("EDIT") to be refunded to OVG's ratepayers is $4,012,142;

ii. We agree that the term of years over which OVG should spread this EDIT refund is 34.25 years;

iii. We agree that the EDIT refund should take the form of an adjustment to OVG's volumetric charges; and

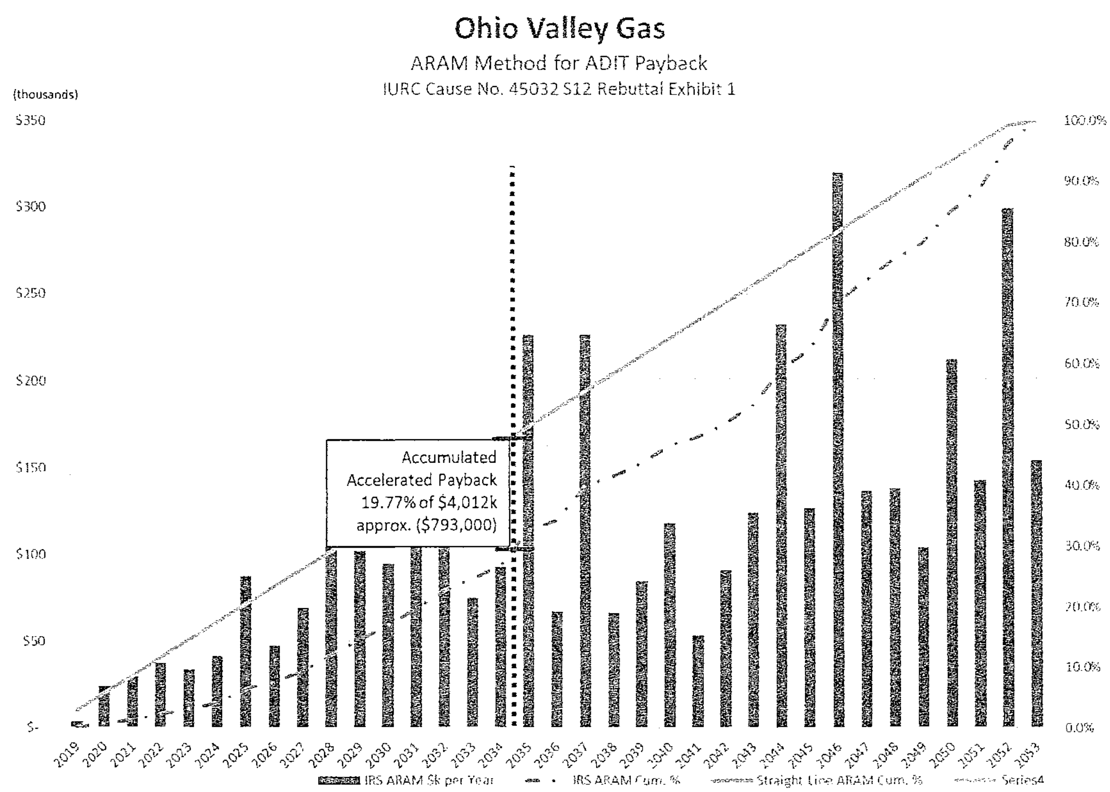
iv. We agree that the separate refund of amounts over-collected between January 1, 2018 and May 1, 2018 should be administered through the use of a temporary tracker for each rate class

Q5: In what areas of this subdocket do you disagree with the OUCC?

A5: The agreed payout period of 34.25 years for the EDIT refund contains 411 months. Mr. Grosskopf has recommended a straight-line payback method of $117,143 each month for 411 months through a change in our volumetric rates. His proposed straight-line method, however, is contrary to Internal Revenue Service (IRS) rules. Furthermore, because this monthly amount is based on the present value of money, it is not equitable to OVG.

Q6. What is your concern regarding the straight-line payback method?

A6. For OVG, its deferred income taxes were created with a significant component coming from large, near term projects and use of bonus depreciation. For example, OVG invested just over $5 million in 2016 on a single project, most of the payment of the deferred taxes on which project will not begin until after 20 years, in other words not until the year 2036. So under ordinary treatment of deferred taxes, the draw down on many of these larger balances will not even start until year 15 or later. Using a straight-line payback model will accelerate the payback of EDIT by approximately $793,000 at its near maximum 16 years into the payback period. See Exhibit 1, below.



Q7. How does this not align with IRS rules?

A7. The IRS rules for normalization prohibit OVG from issuing EDIT refunds on an accelerated basis. Eleven years ago, the IRS issued a private letter ruling ("PLR") to an unidentified "regulated electric utility" concerning, among other things, the appropriate treatment of that utility's EDIT. That private letter ruling (PLR 155208-06 dated July 20, 2007) was publicly released on October 26, 2007 with publication number 200743030 and is attached as Exhibit 2 to my rebuttal testimony. In discussing and explaining the average rate assumption method ("ARAM") which the respondents have also been directed to follow in this subdocket, the IRS determined that "under the ARAM, excess tax reserves pertaining to a particular vintage or vintage account are not flowed through to ratepayers until such time as the timing differences in the particular vintage account reverse." PLR at p. 5 (citation omitted; emphasis added).

OVG takes seriously its responsibility to adhere to IRS normalization rules, especially since the penalties for not doing so could be severe. More recently, the accounting firm KPMG issued its analysis of the TCJA and the law's effects that are "of greatest importance for the power and utility industry." Attached as Exhibit 3 to my rebuttal testimony is a copy of the KPMG publication "Power and utility industry measures in new tax law" dated January 8, 2018. That firm's analysis confirms (on p. 3) that utilities such as OVG should use ARAM to determine the timing of the return of excess deferred taxes and warned that a taxpayer that reduces its excess deferred tax reserve more rapidly than permitted under the normalized method of accounting will be penalized. I also note that while the TCJA was still under consideration in Congress the accounting firm Ernst & Young issued a Tax News Update on November 7, 2017 describing the bill as causing utilities to have "excess accumulated deferred tax balances that would need to be passed on to customers in accordance with current normalization rules. That publication is attached as Exhibit 4 to my rebuttal testimony.

A significant portion of OVG's deferred taxes have an expected payback in later years. Consequently, using the straight-line refund method proposed by the OUCC for refunding the excess deferred taxes resulting from the TCJA would not comport with ARAM, but would instead front-load the payback and would not comply with IRS rules or the advice of respected tax advisors.

Q8. How does the straight-line payback method impact the company's cash?

A8. The straight-line payback method will use the company's cash to payback approximately $793,000 ahead of scheduled payback in the first 16 years. By paying ahead the company is using current dollars that could be invested elsewhere. Also, based on inflation rates, a dollar today is worth more than a dollar in 30 years. Calculating this difference in time is done using a net present value calculation with an assumed interest rate. Using the long-term inflation rate of 3.22% (100 year rate defined by inflationdata.com), and comparing the net present value of the 34.25 years stream of payments, the cost to the company of the straight-line payback model is approximately $385,000. Doing the same calculation using the approved rate case cost of equity at 10%, the net present value cost to the company is approximately $443,000.

Q9. How do you suggest OVG structure the payback method?

A9. After completing the ARAM analysis with the IRS guidance and net present value calculations, OVG still believes the best approach is to use a tiered payback model that mirrors the requirements of the IRS, as I proposed in my direct testimony in this subdocket. Based on discussions with external tax auditors, however, I have modified my recommendation concerning the amount of time allocated to each tier. In order to avoid any issues with the IRS normalization requirements and to properly handle payback from a time value of money perspective, I recommend OVG create 34.25 different tiers (annual changes versus the originally proposed 7 year changes). This would require a rate change annually which would allow for a "true-up" based on the volumetric sales of the previous year.

Q10: Does this conclude your direct testimony.

A10: Yes.

Exhibit 2

to Klinker Rebuttal Testimony

IURC Cause No. 45032-S12

Internal Revenue Service

Number: **200743030**
Release Date: 10/26/2007

Index Number: 167.22-01

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:PSI:B06
PLR-155208-06

Date:
July 20, 2007

LEGEND:

Taxpayer =

PriorCo =
Subsidiary =
Generating =
State =
Commission =
Act =
Application =
Method =
x =
y =
z =
Director =

Dear :

This letter responds to the request, dated November 27, 2006, filed on behalf of Taxpayer for a ruling on the normalization effects of the treatment of two of Taxpayer's deferred tax accounts as proposed by the Commission. The accounts are excess deferred federal income tax (EDFIT), consisting of deferred taxes described in § 203(e) of the Tax Reform Act of 1986, and accumulated deferred investment tax credits (ADITC) under former § 46(f) of the Internal Revenue Code.

The representations set out in your letter follow.

Taxpayer conducts its regulated electric utility business through Subsidiary, an LLC formed under the laws of State and treated as a disregarded entity for federal tax purposes. Taxpayer is engaged, through Subsidiary, in the business of providing electric transmission and distribution services to retail electric providers in State. Taxpayer's primary business, conducted as PriorCo, had traditionally been the generation, transmission, and distribution of electric power. It is subject to the regulatory jurisdiction of Commission.

State enacted the Act, providing for restructuring of electric utilities in State. Act requires generally that electric utilities in State separate their generation, transmission and distribution, and retail electric provider elements into separate units. PriorCo, a corporation formed under the laws of State, of which Taxpayer is the successor for federal tax purposes, conveyed all of its electric generation facilities to Generating on .

. In ,

Taxpayer submitted Application, seeking recovery of $x. In , Commission issued its final order, allowing Taxpayer to recover $y, which included interest through .

,

Among the issues raised is the Commission's reduction of the amount of stranded costs that Taxpayer is allowed to recover by approximately $z, the net present value of the Taxpayer's EDFIT and ADITC balances with respect to certain former generation assets.

Commission, in its order of , ordered that the stranded costs recoverable by Taxpayer be reduced by the net present value of Taxpayer's ADITC balance associated with certain former generation assets and by the net present value of its EDFIT balance. Taxpayer had argued to the Commission that flowing the economic benefits of the unamortized ADITC and EDFIT to ratepayers by reducing the amount of stranded costs recoverable by Taxpayer after the distribution assets were transferred would violate the normalization provisions of the Code. Taxpayer and Commission request a ruling concerning whether requiring Taxpayer to reduce the stranded costs recoverable by the net present value of Taxpayer's ADITC balance associated with certain former generation assets and by the net present value of its EDFIT balance would violate the normalization rules set forth in former section 46(f)(2) and section 168(i)(9)

EDFIT.

Section 168(f)(2) of the Code provides that the depreciation deduction determined under section 168 shall not apply to any public utility property (within the meaning of section 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

In order to use a normalization method of accounting, section 168(i)(9)(A)(i) of the Code requires the taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes. Under section 168(i)(9)(A)(ii), if the amount allowable as a deduction under section 168 differs from the amount that-would be allowable as a deduction under section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under section 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 168(i)(9)(B)(i) of the Code provides that one way the requirements of section 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such requirements. Under section 168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under section 168(i)(9)(A)(ii), unless such estimate or projection is also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base.

Former section 167(l) of the Code generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a "normalization method of accounting." A normalization method of accounting was defined in former section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A). Section 1.167(1)-1(a)(1) of the Income Tax Regulations provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items.

Section 1.167(l)-1(h)(1)(i) of the regulations provides that the reserve established for public utility property should reflect the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes.

Section 1.167(1)-1(h)(1)(iii) of the regulations provides that the amount of federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the amount of the actual tax liability. This amount shall be taken into account for the taxable year in which the different methods of depreciation are used.

Section 1.167(1)-1(h)(2)(i) of the regulations provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that the aggregate amount allocable to deferred taxes may be reduced to reflect the amount for any taxable year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under section 1.167(1)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used for determining the allowance for depreciation under section 167(a).

Section 203(e) of the Act provides another way in which a normalization method of accounting is not being used for public utility property.

According to section 203(e)(1) of the Act, a normalization method of accounting shall not be treated as being used with respect to any public utility property for purposes of section 167 or 168 of the Code if the taxpayer, in computing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, reduces the excess tax reserve more rapidly or to a greater extent that this reserve would be reduced under the average rate assumption method (ARAM).

The term "excess tax reserve" is defined in section 203(e)(2)(A) of the Act as the excess of:

(i) the reserve for deferred taxes as described in former section 167 (1)(3)(G)(ii) or 168(e)(3)(B) (ii) of the Code as in effect on the day before the date of the enactment of the Act, over;

(ii) the amount that would be the balance in this reserve if the amount of the reserve were determined by assuming that the corporate rate reductions provided in the Act were in effect for all prior periods.

Section 203(e)(2)(B) of the Act defines the ARAM and explains the calculations under this method. ARAM is the method under which the excess in the reserve for deferred taxes is reduced over the remaining lives of the property as used in its books of account that gave rise to the reserve for deferred taxes. Under the ARAM, if timing differences for the property reverse, the amount of the adjustment to the reserve for the deferred taxes is calculated by multiplying:

(i) the ratio of the aggregate deferred taxes for the property to the aggregate timing differences for the property as of the beginning of the period in question, by;

(ii) the amount of the timing differences that reverse during this period.

Rev. Proc. 88-12, 1988-1 C.B. 637, provides further guidance as to the application of the ARAM to the excess tax reserve. Section 2.04 of Rev. Proc. 88-12 provides that under the ARAM, excess tax reserves pertaining to a particular vintage or vintage account are not flowed through to ratepayers until such time as the timing differences in the particular vintage account reverse. Moreover, it is a violation of section 203(e) of the Act for taxpayers to adopt any accounting treatment that, directly or indirectly, circumvents the rule set forth in the previous sentence. Section 2.04 also provides that section 203(e) of the Act does not modify the normalization requirements of former section 167(l) or section 168(i) of the Code.

Sections 3 and 4.01 of Rev. Proc. 88-12 provide that a taxpayer who lacks sufficient vintage account data necessary to apply the ARAM, can use the "Reverse South Georgia Method." In general, a taxpayer uses that method if it (a) computes the excess tax reserve on all public utility property included in the plant account on the basis of the weighted average life or composite rate used to compute depreciation for regulatory purposes, and (b) reduces the excess tax reserve ratably over the remaining regulatory life of the property.

For a public utility to use accelerated depreciation in determining its federal income tax liability, section 203(e) of the Act requires that normalization accounting be used to reduce the excess tax reserve in calculating the rates to be charged the utility's customers and in maintaining the regulated books of account. Under section 203(e) of the Act, the immediate flow through of the excess tax reserve to the utility's customers is prohibited. Instead, the excess tax reserve is to be reduced and flowed through to cost of service no more rapidly that this reserve would be reduced under the ARAM, or, where appropriate, the Reverse South Georgia Method.

Section 203 (e) of the Act limits the rate at which the excess tax reserve may be reduced and flowed through to the utility's customers in setting rates. It does not require the utility to flow through the excess tax reserve to its customers, but permits the utility to do so provided the reduction to cost of service is not more rapidly than would be under the ARAM. Thus, section 203 (e) of the Act imposes a limitation on when the excess tax reserve may be returned to the utility's customers in the form of reduced rates.

In the present case, Taxpayer has transferred the generating assets. Retirements of public utility property subject to the normalization requirements of section 168 are reflected in adjustments to the deferred tax reserve as well as its depreciation expense). If cost of service is reduced annually by an amount computed by applying a composite annual percentage rate to the amount of the credit, cost of service is reduced by a ratable portion. If such composite annual percentage rate were revised for purposes of computing depreciation expense beginning with a particular accounting period, the computation of ratable portion must also be revised beginning with such period. A composite annual percentage rate is determined solely by reference to the period of time actually used by the taxpayer in computing its regulated depreciation expense without reduction for salvage or other items such as over and under accruals.

The method prescribed by section 1.46-6(g)(2) of the regulations for determining whether the taxpayer's cost of service for ratemaking is reduced by more than a ratable portion of the investment tax credit depends upon correlating the credit with the regulatory depreciable useful life actually used for the property that generated the credit. That the correlation must remain constant and current is illustrated by the requirement that the ratable portion must be adjusted to reflect correspondingly any revision to the composite annual percentage rate applied for purposes of computing regulated depreciation expense.

Should the property for which the investment tax credit is allowed become no longer available for computing the regulated depreciation expense, there could no longer be any correlation between the property and the credit. In that event, the requirements of former section 46(f)(2) of the Code are violated if any portion of the credit is used to reduce the taxpayer's cost of service.

In this case, Taxpayer has transferred the assets that generated the investment tax credit and, as a result, the asset for which regulated depreciation expense is computed is no longer available. Consequently, no portion of the related unamortized ADITC remaining at the date of sale may be used to directly or indirectly reduce Taxpayer's cost of service.

Thus, Taxpayer will violate the requirements of the investment tax credit normalization rules set forth in former section 46(f), if it decreases its stranded costs by the net present value of the ADITC balance associated with the generation assets.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

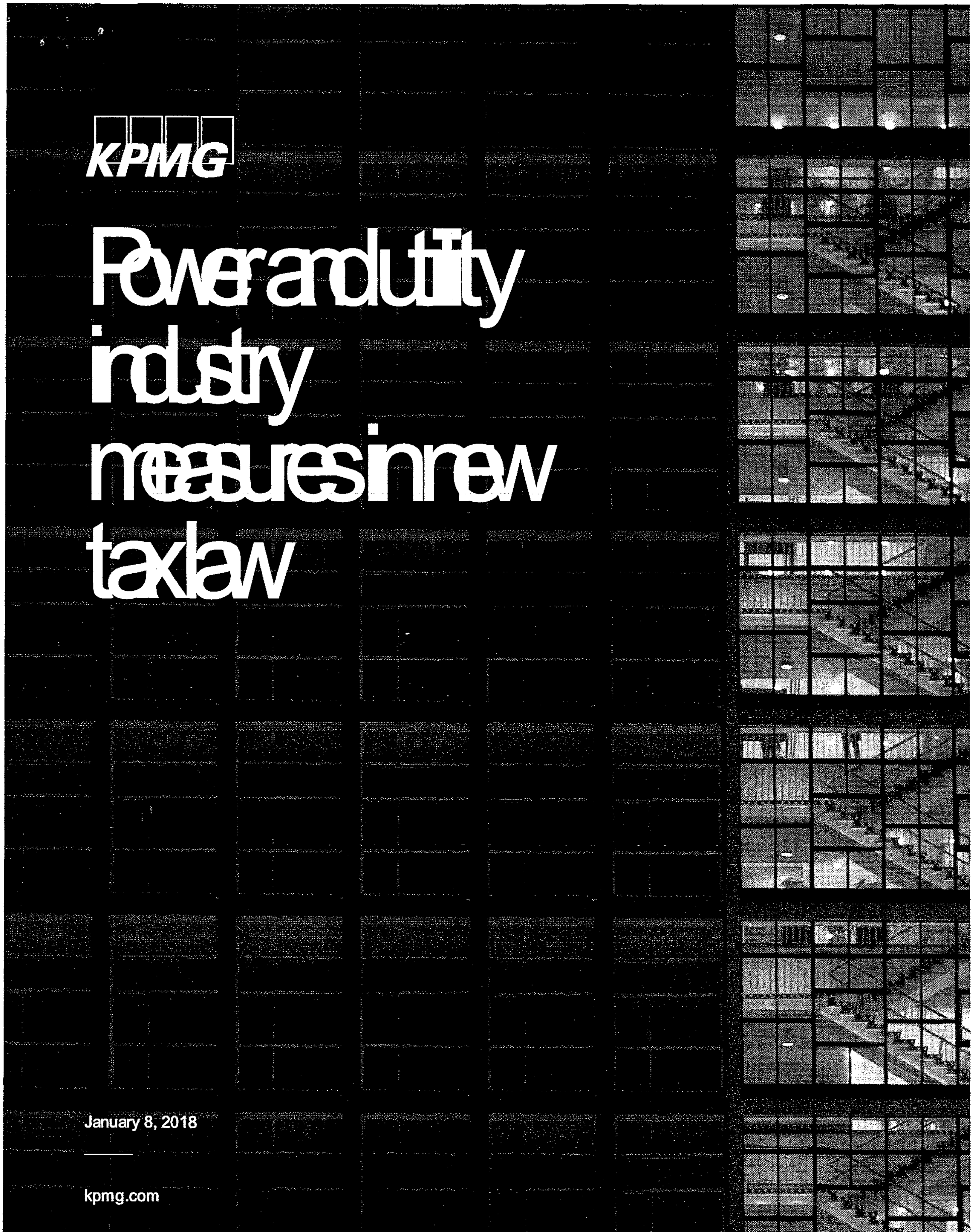
Sincerely,

Peter C. Friedman
Senior Technican Reviewer, Branch 6
(Passthroughs & Special Industries)

Exhibit 3

to Klinker Rebuttal Testimony

IURC Cause No. 45032-S12



Power and utility industry measures in new tax law

January 8, 2018

kpmg.com

Introduction

The president on December 22, 2017, signed into law H.R. 1, originally known as the "Tax Cuts and Jobs Act." The new law represents the culmination of a lengthy process in pursuit of business tax reform over the course of more than 20 years.

The legislation includes substantial changes to the taxation of individuals as well as U.S. businesses, multi-national enterprises, and other types of taxpayers. Overall, it provides a net tax reduction of approximately $1.456 trillion over the 10-year "budget window" (according to estimates provided by the Joint Committee on Taxation (JCT) that do not take into account macroeconomic/dynamic effects). Highlights of provisions that impact the power and utility industry include:

- A permanent reduction in the statutory C corporation tax rate to 21% with statutory provisions requiring that excess tax reserves associated with public utility property be normalized

- Repeal of the corporate alternative minimum tax (AMT)

- Expensing of capital investment with an exception for property predominantly used in certain rate regulated trade or businesses

- Limitation of the deduction for interest expense with an exception for interest expense properly allocable to certain rate regulated trade or businesses

- Modification to the capital contribution rules under section 118

- Fundamental changes to the taxation of multinational entities, including a shift from the current system of worldwide taxation with deferral to a hybrid territorial system, featuring a participation exemption regime with current taxation of certain foreign income, a minimum tax on low-taxed foreign earnings, and new measures to deter base erosion and promote U.S. production

The following discussion provides initial analysis and observations regarding the tax law changes in H.R. 1 that are considered to be of greatest importance for the power and utility industry.

Read a 167-page report prepared by KPMG that examines the provisions in the new tax law and provides observations: New tax law (H.R. 1) – Initial observations [PDF 1.4 MB]

Documents

- Read text of the tax bill, H.R. 1 [PDF 491 KB] (185 pages)
- The conference agreement [PDF 4.25 MB] (1097 pages) includes (1) bill language, (2) an explanatory statement, and (3) a preliminary revenue table prepared by the staff of the Joint Committee on Taxation (JCT).
- Read the CBO cost estimate for the conference agreement on H.R. 1.
- The JCT provided estimates of the budget effects of the conference agreement on H.R. 1. Read JCX-67-17
- Read JCX-68-17 (Distributional Effects of the Conference Agreement for H.R. 1)
- Read JCX-69-17 (Macroeconomic Analysis of the Conference Agreement for H.R. 1)

Reductions in corporate tax rate and dividends received deduction

The new law eliminates the progressive corporate tax rate structure, currently imposing a maximum corporate tax rate of 35%, and replaces it with a flat tax rate of 21% (and makes various corresponding changes throughout the Code). The new rate is effective for tax years beginning after 2017. In addition, the new law lowers the 80% dividends received deduction (for dividends from 20% owned corporations) to 65% and the 70% dividends received deduction (for dividends from less than 20% owned corporations) to 50%, effective for tax years beginning after 2017.

The new law also repeals the alternative corporate tax on net capital gain (prior law Code section 1201).

The JCT has estimated that the rate reduction will decrease revenues by approximately $1.35 trillion over 10 years.

KPMG observation

This reduction is intended to make the U.S. corporate tax rate more competitive with the rates imposed by other countries. Consistent with the overall theme of the new law, this provision lowers tax rates in exchange for the elimination of certain tax benefits.

Section 15 generally results in the application of a "blended" tax rate for tax years of fiscal year taxpayers that include the effective date of the rate change (December 31, 2017).

The new law's 21% corporate tax rate is slightly higher than the 20% rate proposed in the House and Senate bills. The effective date of the change is the same as in the House bill, but reflects a one-year acceleration from the effective date provided by the Senate bill.

The House and Senate bills had modified the dividends received deduction to provide parity between the marginal tax rate on dividends received by corporations (1) under current law and (2) at a 20% rate. The new law does not further adjust the dividends received deduction to reflect the increase in the corporate rate to 21%.

The corporate rate under the new law is substantially below the top individual tax rate (37%), which re-establishes the relationship between these tax rates that was in place beginning with the enactment of the Revenue Act of 1913 until the enactment of the Tax Reform Act of 1986.

Excess deferred taxes for public utility property

As part of the corporate rate reduction, the new law provides that a normalization method of accounting is used for excess tax reserves associated with public utility property. Consistent with the Tax Reform Act of 1986, the measure would provide for the use of the average rate assumption method (ARAM) for the determination of the timing of the return of excess deferred taxes. However, the new law also allows for an alternative method if the books and underlying records do not contain the vintage account data necessary to apply ARAM. A new provision is added to address a violation of the normalization requirement. A violation would result in an increase in tax by the amount by which the taxpayer reduces its excess deferred tax reserve more rapidly than permitted under the normalized method of accounting. The final statute differed from the House bill by adding that a violation of the normalization requirement for excess deferred taxes not only results in the aforementioned penalty but is also considered a violation under existing rules. Therefore, there is a loss of the use of accelerated depreciation and a cash penalty.

The conference committee report includes the following discussion and example of ARAM:

The average rate assumption method reduces the excess tax reserve over the remaining regulatory lives of the property that gave rise to the reserve for deferred taxes during the years in which the deferred tax reserve related to such property is reversing. Under this method, the excess tax reserve is reduced as the timing differences (i.e., differences between tax depreciation and regulatory depreciation with respect to the property) reverse over the remaining life of the asset. The reversal of timing differences generally occurs when the amount of the tax depreciation taken with respect to an asset is less than the amount of the regulatory depreciation taken with respect to the asset. To ensure that the deferred tax reserve, including the excess tax reserve, is reduced to zero at the end of the regulatory life of the asset that generated the reserve, the amount of the timing difference which reverses during a taxable year is multiplied by the ratio of (1) the aggregate deferred taxes as of the beginning of the period in question to (2) the aggregate timing differences for the property as of the beginning of the period in question.

The following example illustrates the application of the average rate assumption method. A calendar year regulated utility placed property costing $100 million in service in 2016.

For regulatory (book) purposes, the property is depreciated over 10 years on a straight line basis with a full year's allowance in the first year. For tax purposes, the property is depreciated over 5 years using the 200% declining balance method and a half-year placed in service convention.

Normalization calculation for corporate rate reduction (Millions of dollars)

	Year(s)										
	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	Total
Tax expense	20	32	19.2	11.52	11.52	5.76	0	0	0	0	100
Book depreciation	10	10	10	10	10	10	10	10	10	10	100
Timing difference	10	22	9.2	1.52	1.52	(4.24)	(10)	(10)	(10)	(10)	0
Tax rate	35%	35%	21%	21%	21%	31.1%	31.1%	31.1%	31.1%	31.1%	
Annual adjustment to reserve	3.5	7.7	1.9	0.3	0.3	(1.3)	(3.1)	(3.1)	(3.1)	(3.1)	0
Cumulative tax reserve	3.5	11.2	13.1	13.5	13.8	12.5	9.3	6.2	3.1	(0.0)	0
Annual adjustment at 21%						(0.9)	(2.1)	(2.1)	(2.1)	(2.1)	(9.3)
Annual adjustment at average rate						(1.3)	(3.1)	(3.1)	(3.1)	(3.1)	(13.8)
Excess tax reserve						0.4	1.0	1.0	1.0	1.0	4.5

The excess tax reserve as of December 31, 2017, the day before the corporate rate reduction takes effect, is $4.5 million. The taxpayer will begin taking the excess tax reserve into account in the 2021 taxable year, which is the first year in which the tax depreciation taken with respect to the property is less than the depreciation reflected in the regulated books of account. The annual adjustment to the deferred tax reserve for the 2021 through 2025 taxable years is multiplied by 31.1% which is the ratio of the aggregate deferred taxes as of the beginning of 2021 ($13.8 million) to the aggregate timing differences for the property as of the beginning of 2021 ($44.2 million).

Limitation on the deduction of net business interest expense

The new law amends section 163(j) to disallow a deduction for net business interest expense of any taxpayer in excess of 30% of a business's adjusted taxable income plus floor plan financing interest. The explanatory statement indicates that the section 163(j) limitation should be applied after other interest disallowance, deferral, capitalization or other limitation provisions. Thus, the provision would apply to interest deductions that are deferred in the tax year in which such deductions are deferred, capitalized, or disallowed.

The new limitation does not apply to business interest expense that is properly allocable to the trade or business of furnishing or selling electrical energy, water or sewage disposal services, gas or steam through a local distribution system, or transportation of gas or steam by pipeline if the rates for such furnishing or sale are subject to rate regulation or by the governing or ratemaking body of an electric cooperative

KPMG observation

It is unclear how to determine what is "properly allocable to a trade or business". Business interest not properly allocable to the delineated regulated businesses would be subject to potential disallowance.

Adjusted taxable income generally is a business's taxable income computed without regard to: (1) any item of interest, gain, deduction, or loss that is not properly allocable to a trade or business; (2) business interest or business interest income; (3) the amount of any net operating loss deduction; (4) the 20% deduction for certain passthrough income, and (5) in the case of tax years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion. The new law permits the Treasury Secretary to provide other adjustments to the computation of adjusted taxable income. A business's adjusted taxable income may not be less than zero for purposes of the limitation.

Business interest is defined as any interest paid or accrued on indebtedness properly allocable to a trade or business. Any amount treated as interest for tax purposes is treated as "interest" for purposes of this provision. The term "business interest" does not include investment interest within the meaning of section 163(d).

Subject to the exclusions or those businesses that may elect out, the provision applies to all businesses, regardless of form, and any disallowance or excess limitation would generally be determined at the filer level (e.g., at the partnership level instead of the partner level). For a group of affiliated corporations that join in filing a consolidated return, the conference report's explanatory statement says that the provision applies at the consolidated tax return filing level, although the provision itself does not address this point. Subject to the special rules for partnerships, any business interest disallowed would be carried forward indefinitely. Carryover amounts are taken into account in the case of certain corporate acquisitions described in section 381 and are subject to limitation under section 382.

Special carryforward rules, described below, apply to partners in the case of business interest not allowed as a deduction to a partnership.

The new law prevents a partner from double counting a partnership's adjusted taxable income when determining the partner's business interest limitation. More specifically, a partner's adjusted taxable income is determined without regard to the partner's distributive share of the partnership's items of income, gain, deduction, or loss.

The explanatory statement illustrates the double counting rule with the following example.

> *ABC is a partnership owned 50-50 by XYZ Corporation and an individual. ABC generates $200 of noninterest income. Its only expense is $60 of business interest.*

Under the provision, the deduction for business interest is limited to 30% of adjusted taxable income, that is, 30% x $200 = $60. ABC deducts $60 of business interest and reports ordinary business income of $140. XYZ's distributive share of the ordinary business income of ABC is $70. XYZ has net taxable income of zero from its other operations, none of which is attributable to interest income and without regard to its business interest expense. XYZ has business interest expense of $25. In the absence of a double counting rule, the $70 of taxable income from XYZ's distributive share of ABC's income would permit XYZ to deduct up to an additional $21 of interest (30% x $70 = $21), and XYZ's $100 share of ABC's adjusted taxable income would generate $51 of interest deductions, well in excess of the intended 30% limitation. If XYZ were a passthrough entity rather than a corporation, additional deductions might be available to its partners as well, and so on.

The double counting rule prevents this result by providing that XYZ has adjusted taxable income computed without regard to the $70 distributive share of the nonseparately stated income of ABC. As a result, it has adjusted taxable income of $0. XYZ's deduction for business interest is limited to 30% x $0 = $0, resulting in a deduction disallowance of $25.

The new law allows a partner to use its distributive share of any excess (i.e., unused) taxable income limitation of the partnership or in computing the partner's business interest limitation. The excess taxable income with respect to any partnership is the amount that bears the same ratio to the partnership's adjusted taxable income as the excess (if any) of 30% of the adjusted taxable income of the partnership over the amount (if any) by which the business interest of the partnership exceeds the business interest income of the partnership bears to 30% of the adjusted taxable income of the partnership. Any such excess adjusted taxable income is allocated in the same manner as nonseparately stated income and loss.

The explanatory statement provides the following example.

*Assume the partnership described above had only $40 of business interest. ABC has a limit on its interest deduction of $60. The excess of this limit over the business interest of the partnership is $60 - $40 = $20. The excess taxable income for ABC is $20 / $60 * $200 = $66.67. XYZ's distributive share of the excess taxable income from ABC partnership is $33.33. XYZ's deduction for business interest is limited to 30% of the sum of its adjusted taxable income plus its distributive share of the excess taxable income from ABC partnership (30%* ($0 + $33.33) = $10). As a result of the rule, XYZ may deduct $10 of business interest and has an interest deduction disallowance of $15.*

As noted earlier, special carryforward rules apply to partners and partnership. Excess business interest of a partnership is not treated as paid or accrued by the partnership in the succeeding tax year. Instead excess business interest is allocated to each partner in the same manner as the nonseparately stated taxable income or loss of the partnership.

Excess business interest allocated to a partner is treated as business interest paid or accrued by the partner in the next succeeding tax year in which the partner is allocated excess taxable income from the partnership but only to the extent of such excess taxable income. Any remaining excess business interest can be carried forward by the partner and deducted subject to the excess taxable income limitation. A partner's adjusted basis in its partnership interest is reduced (but not below zero) by the amount of excess business interest allocated to the partner. If a partner disposes of its partnership interest, including in a non-recognition transaction, the partner's basis in the interest is increased, immediately prior to the disposition, by the excess of: (i) the amount basis was reduced as described above over (ii) the amount of excess business interest allocated to the partner and treated as paid or accrued in a succeeding tax year.

The provision is effective for tax years beginning after 2017.

The JCT has estimated the provision will increase revenues by approximately $253.4 billion over 10 years.

KPMG observation

Under the new law, any net interest disallowance applies at the filer level rather than the taxpayer level. Thus, the determination is made at the partnership rather than the partner level. This affects not only the determination of any interest disallowance, but also any excess amount (i.e., interest expense capacity) passed through from a partnership to its partners. There may also be uncertainties created when applying the rules at the partnership level when references are made to the rules of section 469 which apply at the partner level.

Special rules allow a partnership's unused interest limitation for the year to be used by its partners and to ensure that net income from the passthrough entity are not double counted at the partner level. With respect to the double-counting rule, the new law excludes a partner's distributive share of all partnership items.

The new law permits interest disallowed at the partnership level to be passed through to the partners and deducted in succeeding tax years in which, and to the extent that, the partners are allocated excess taxable income from such partnership. The new law also provides for adjustments to the partners' bases in partnership interests to account for disallowed interest that is passed through.

The new provision applies only to business interest expense of the taxpayer. Nonbusiness interest, such as investment interest expense, continues to be subject to the limitation on investment interest. In addition, payments that are not interest such as capitalized debt costs that are amortized like OID under Reg. section 1.446-5 are not included.

The provision includes only taxable interest income in the computation of net business interest expense. Thus, investments in tax-free municipal bonds do not increase a taxpayer's interest expense capacity.

While the new law does not explicitly indicate how the new rule interacts with other interest disallowance and deferral provisions, the explanatory statement indicates that the provision is intended to apply after other interest disallowance and deferral provisions.

In addition, there appear to be no special rules for financial services entities. As a result, the determination of net business interest expense is unclear for a company like an insurer that generates significant interest income related to investments as an integral part of its active insurance business.

It should be noted that interest expense can occur as a result of repurchasing one's debt instrument at a premium. Under Reg. section 1.163-7(c), if a borrower repurchases its debt instrument for an amount in excess of its adjusted issue price, the repurchase premium is deductible as interest for the tax year in which the repurchase occurs, unless the deduction for the repurchase premium is disallowed under section 249 or the repurchase premium was the result of certain debt-for-debt exchanges.

Finally, the new provision does not address what happens to a corporation's existing disallowed interest expense for which a deduction was not claimed because of existing section 163(j). Thus, it is unclear if Congress intends that a corporation may treat that disallowed interest expense as business interest paid or accrued in a year after the effective date of the provision.

Cost recovery

Temporary 100% expensing for certain business assets

The new law extends and modifies the additional first-year depreciation deduction ("bonus depreciation").

Under the new law, generally, the bonus depreciation percentage is increased from 50% to 100% for property acquired and placed in service after September 27, 2017, and before 2023. It also provides a phase down of the bonus depreciation percentage, allowing an 80% deduction for property placed in service in 2023, a 60% deduction for property placed in service in 2024, a 40% deduction for property placed in service in 2025, and a 20% deduction for property placed in service in 2026. These same percentages apply to specified plants planted or grafted after September 27, 2017, and before 2027. Longer production period property and certain aircraft get an additional year to be placed in service at each rate.

Property that is acquired prior to September 28, 2017, but placed in service after September 27, 2017, remains subject to the bonus depreciation percentages available under current law—i.e., 50% for property placed in service in 2017, 40% for property placed in service in 2018, and 30% for property placed in service in 2019. Under the new law, the acquisition date for property acquired pursuant to a written binding contract is the date of such contract.

KPMG observation

Prior legislation, and IRS regulations issued in 2003 interpreting such legislation, provided specific rules for determining the acquisition date of self-constructed property for bonus depreciation purposes. The new law, however, is silent as to the determination of the acquisition date for self-constructed property. Thus, it is unclear whether prior law standards will be used for acquisition date determinations for self-constructed property under the new rules.

The new law changes the definition of qualified property (i.e., property eligible for bonus depreciation) by including used property acquired by purchase so long as the acquiring taxpayer has not previously used the acquired property and so long as the property is not acquired from a related party.

In addition, the new law excludes any property used in providing certain utility services if the rates for furnishing those services are subject to ratemaking by a government entity or instrumentality or by a public utility commission.

KPMG observation

As in the House and Senate bills, the new law excludes from bonus-eligible qualified property any property used in trades or businesses that is not subject to the limitation of net business interest expense under section 163(j).

The change in the definition of qualified property could have an important effect on M&A transactions. It increases the incentive for buyers to structure taxable acquisitions as actual or deemed (e.g., pursuant to section 338) asset purchases, rather than stock acquisitions, by enabling the purchasing entity in an asset acquisition to immediately deduct a significant component of the purchase price, and potentially to generate net operating losses in the year of acquisition that could be carried forward (subject, in general, to an 80% of taxable income limitation as described elsewhere in this document) to shield future income.

In the case of a taxpayer's first tax year ending after September 27, 2017, the new law permits the taxpayer to elect to apply a 50% allowance in lieu of 100%.

The JCT has estimated that the provision will decrease revenues by approximately $86.3 billion over 10 years.

KPMG observation

The new law incorporates the most favorable provisions of both the House and Senate bills by expanding the availability of bonus depreciation to purchased non-original use property, and by instituting a four-year phase down period from 2023 through 2026.

Corporate AMT

The new law repeals the corporate AMT effective for tax years beginning after December 31, 2017. Any AMT credit carryovers to tax years after that date generally may be utilized to the extent of the taxpayer's regular tax liability (as reduced by certain other credits). In addition, for tax years beginning in 2018, 2019, and 2020, to the extent that AMT credit carryovers exceed regular tax liability (as reduced by certain other credits), 50% of the excess AMT credit carryovers are refundable (there is a proration rule with respect to short tax years). Any remaining AMT credits will be fully refundable in 2021.

The JCT has estimated that the repeal of the corporate AMT will reduce revenues by approximately $40.3 billion over a 10-year period.

KPMG observation

Repealing the corporate AMT eliminates some of the complexity inherent in U.S. corporate taxation. For taxpayers with significant corporate AMT credit carryovers, the new law allows the full use of the credits to (i) reduce or eliminate regular tax liability, and (ii) obtain tax refunds to the extent the AMT credit carryovers exceed regular tax liability.

While the new law repeals the AMT, it also generally limits the NOL deduction for a given year to 80% of taxable income, adding a more restrictive version of the 90% limitation that previously existed only in the AMT regime. As shorthand, the 90% limitation in the AMT regime can be viewed as imposing a 2% tax rate (20% AMT rate multiplied by the 10% of income that cannot be offset with an NOL deduction). This "shorthand" rate is 4.2% under the new law (21% corporate tax multiplied by the 20% of income that cannot be offset with NOLs).

The repeal of the corporate AMT in the new law is consistent with the House bill but represents a change from the Senate bill, which would have retained the corporate AMT. The Senate bill's preservation of the corporate AMT, when combined with its 20% corporate tax rate, would have increased the number of corporations subject to the AMT and would have resulted in significant collateral consequences and additional complexity.

Natural resources

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)). Section 59(f) (which coordinates section 59(e) with section 291) is repealed by the new law. It appears that Congress did not expect corporations to use section 59(e) after 2017. A corporation with domestic NOLs and foreign source income covered by foreign tax credits may want to consider using section 59(e) to eliminate the domestic NOL.

Modified net operating loss (NOL) deduction

The new law limits the NOL deduction for a given year to 80% of taxable income, effective with respect to losses arising in tax years beginning after December 31, 2017. This limitation is similar to, although more restrictive than, the current 90% limitation for NOLs in the corporate AMT regime (which, as indicated above, is repealed by the new law).

The new law also repeals the current carryback provisions for NOLs; the statutory language indicates that this provision applies to NOLs arising in tax years ending after December 31, 2017, although it permits a new two-year carryback for certain farming losses and retains present law for NOLs of property and casualty insurance companies. Prior law generally provided a two-year carryback and 20-year carryforward for NOLs, as well as certain carryback rules for specific categories of losses (e.g., "specified liability losses" may be carried back 10 years). The repeal of the existing carryback provisions includes the repeal of the carryback limitations applicable to corporate equity reduction transactions (CERTs). The CERT rules are intended to prevent corporations from financing leveraged acquisitions or distributions with tax refunds generated by the carryback of interest deductions resulting from the added leverage. If applicable, the CERT rules can limit the amount of a NOL that can be carried to tax years preceding the year of the CERT.

The statutory language of the new law provides for the indefinite carryforward of NOLs arising in tax years ending after December 31, 2017, as opposed to the current 20-year carryforward.

The JCT has estimated that the provision will increase revenue by approximately $201.1 billion over 10 years (approximately $45 billion more than the estimates for each of the House and Senate proposals).

KPMG observation

The new law does not appear to limit the three-year capital loss carryback allowed for corporations or impose a limitation on the utilization of capital loss carryovers.

The new law requires corporations to track NOLs arising in tax years beginning (1) on or before December 31, 2017, and (2) after December 31, 2017, separately, as only the latter category of NOLs would be subject to the 80% limitation.

The 80% limitation applies to losses arising in tax years <u>beginning</u> after December 31, 2017, whereas the statutory language regarding the indefinite carryover and the elimination (for most taxpayers) of the NOL carryback applies to losses arising in tax years <u>ending</u> after December 31, 2017. Accordingly, the NOLs of fiscal year taxpayers arising in tax years that <u>begin</u> before December 31, 2017 and <u>end</u> after December 31, 2017 would not be subject to the 80% limitation but (for most taxpayers) may not be carried back and may be carried forward indefinitely. In addition, the conference report's explanatory statement describes the effective date for the indefinite carryover and modification of carrybacks differently, indicating that the provision applies to losses arising in tax years beginning after December 31, 2017.

The changes to the NOL carryover provisions possibly may have a significant effect on the financial statement treatment of loss carryovers incurred in future tax years, given that unused loss carryovers no longer will expire. In addition, the potential 80% limitation on post-2017 NOLs and the elimination of post-2017 NOL carrybacks, combined with the reduction of the corporate tax rate, provides corporations with a significant incentive to accelerate deductions into 2017 and to defer income into 2018. In general, taxpayers may find it beneficial to stagger purchases as long as full expensing is available, or selectively elect out of full expensing for property in one or more depreciation recovery classes during this period, if doing so would avoid creating or increasing NOLs subject to the 80% limitation.

The NOL changes also remove the counter-cyclical effect of loss carrybacks in that corporations generating losses due to a business downturn or due to large environmental or product liability payments no longer will be able to carry back losses to obtain refunds of taxes paid in prior years.

The new law does not include a formula to increase NOL carryforwards by an interest factor over time, as was provided in the House bill.

Revisions to treatment of capital contributions

The new law modifies section 118, which provides an exclusion from gross income for contributions to the capital of a corporation. Specifically, the new law excludes from section 118 any "contribution in aid of construction" (CIAC) or any other contribution as a customer or potential customer, as well as any contribution by any government entity or civic group (other than a contribution made by a shareholder as such). The previous exception under section 118(c) for CIAC's received by water and sewerage disposal utilities has been repealed. This provision applies to contributions made after the date of enactment, unless the contribution is made by a government entity pursuant to a master development plan that is approved prior to the effective date by a government entity.

The JCT has estimated that the provision will increase revenue by approximately $6.5 billion over 10 years.

KPMG observation

The new law's modifications to section 118 generally require corporations to include the specified types of contributions in gross income.

The new law significantly modifies the corresponding provision in the House bill (the Senate bill did not include a similar provision), which would have repealed Code sections 118 (that provides for nonrecognition by a corporation on the receipt of a contribution to capital) and 108(e)(6) (that harmonizes the discharge of indebtedness income rules with section 118) and enacted new Code section 76 (that affirmatively would have required corporations and partnerships to recognize income on the receipt of a contribution to capital). The report on the House bill indicated that these changes were intended to eliminate a federal tax subsidy for state and local incentives and concessions granted to corporations to incentivize them to locate operations within the grantor's jurisdiction. However, the changes in the House bill would have applied to a much broader range of situations than suggested by the policy description and would have created a number of apparently unintended and unexpected consequences, including a particularly destabilizing impact on workouts and efforts to rehabilitate troubled companies.

The summary explanation notes that the new law follows the policy of the House bill, but takes a different approach. The new law eliminates the House bill's specific section 76 recognition provision and limits section 118 nonrecognition in a manner consistent with the policy justification given for the House bill. This approach avoids many of the problematic and uncertain consequences raised by the House bill. See "Critique of House's Treatment of Capital Contributions," Tax Notes, Dec. 11, 2017, p. 1641.

The summary explanation also notes that the conferees, consistent with the IRS current view, intend that section 118, as modified, continue to apply only to corporations.

Repeal deduction for income attributable to domestic production activities

Under the new law, the deduction for domestic production activities provided under section 199 is repealed for tax years beginning after December 31, 2017.

JCT has estimated that repealing section 199 will increase revenues by approximately $98 billion from 2018-2027.

KPMG observation

Congress's intent in enacting section 199 was to provide a targeted corporate rate reduction that would allow U.S. companies to compete against international tax systems, while also drawing international companies to the United States and its tax structure. While the new law eliminates the rate reduction created by section 199, a separate provision of the legislation effects a much larger overall corporate rate reduction, as discussed above.

The repeal of section 199 applies to tax years beginning after December 31, 2017, so fiscal year taxpayers would still be able to claim the section 199 deduction for fiscal years ending after December 31, 2017, but beginning before the repeal date. In addition, as discussed above, special rules apply to corporate taxpayers whose tax years straddle the effective date. The rules under section 15 generally result in application of a blended corporate rate to taxable income for the year that straddles the effective date. As a result, fiscal year taxpayers would be eligible for the section 199 deduction as well as partial impact of the 21% corporate tax rate for tax years beginning before January 1, 2018, and ending after December 31, 2017.

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Exhibit 4

to Klinker Rebuttal Testimony

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Recently released Tax Cuts and Jobs Act has implications for energy sector

Chairman Brady released his comprehensive tax reform bill (Tax Cuts and Jobs Act or the House Bill), on November 2, 2017.[1] The House Bill has the potential to foster energy development by encouraging the energy sector, which is very capital intensive, to invest significantly in the United States. That being said, the effects of the bill's other provisions on the sector will require further analysis.

The House Bill would, if enacted in its current form, immediately and permanently reduce the statutory corporate tax rate to 20%, while eliminating many current business tax benefits. Further, the US tax system would move to a territorial system of taxing foreign earnings with anti-base erosion provisions targeting both US-based and foreign-based multinational companies. Significantly, the House Bill includes a new excise tax on otherwise deductible payments from US companies to related foreign companies. The adoption of a territorial tax system includes a one-time transition tax on accumulated foreign earnings, determined as of November 2, 2017, or December 31, 2017 (whichever is higher), at a 12% rate for cash and cash equivalents and a 5% rate for illiquid assets, and payable over up to eight years. For an overview of the House Bill, and its potential application to individuals, accounting methods, and various other sector implications, please see Tax Alert 2017-1831.

Many energy sector companies will have to model the effects of the business provisions of the House Bill to understand their net effect. Aggressive across-the-board tax cuts, including the reduction of the corporate rate to 20%, the repeal of the Alternative Minimum Tax (AMT) and various other provisions would be beneficial. Certain limitations on taxpayers' ability to utilize net operating losses (NOLs) and the repeal of the Section 199 deduction for domestic production activities, however, could be detrimental to certain energy companies. Similarly, while the reduction in the deductibility of net interest will discomfit some taxpayers, certain regulated public utility entities, among others, will be eligible for a limited exemption, at least for the debt associated with their operating companies.

General business provisions that could affect energy companies

While the effect of the House Bill's provisions ought to be analyzed on a company-by-company basis, as well as a sector-by-sector basis, many provisions of the House Bill have general applicability to energy sector companies.

Corporate

The House Bill contains many provisions that would affect corporations, including, but not limited to, the following:

— *20% corporate tax rate* — The new rate would be effective for tax years beginning after 2017.

— *100% expensing* — Taxpayers would be able to expense 100% of the cost of qualified property acquired and placed in service after September 27, 2017, and before January 1, 2023 (with an additional year for certain qualified property with a longer production period). Qualified property would not include any property used by a regulated public utility company or any property used in a real property trade or business.

— *Repeal of corporate AMT* — The House bill would repeal the corporate AMT. Taxpayers would be able to claim a refund of 50% of the remaining credits (to the extent the credits exceed regular tax for the year) in tax years beginning in 2019, 2020 and 2021. Taxpayers would be able to claim a refund of all remaining credits in the tax year beginning in 2022. The provision would generally be effective for tax years beginning after 2017.

— *Research credit* — The research credit would be preserved without modification from current law.

— *Section 199* — The domestic production deduction for qualifying receipts derived from certain activities performed in the United States would be repealed for tax years after 2017.

— *Interest limitation* — Multiple limitations would be provided through revisions to current Section 163(j) and a new Section 163(n) would be added.

— *Net operating losses (NOLs)* — The deduction of an NOL carryforward would be limited to 90% of a C-corporation's taxable income for tax years beginning after December 31, 2017. The carryback provisions would be generally repealed for losses generated in tax years beginning after December 31, 2017, except for a special one-year carryback for certain taxpayers (among other provisions for other sectors). NOLs arising in tax years beginning after 2017 would be allowed to be carried forward indefinitely with an interest factor to preserve their value.

— *Other provisions to be repealed or modified* — Section 179 expensing would be expanded; the like-kind exchange rules would be modified by limiting like-kind exchanges to only those involving real property (to be discussed in further detail); self-created property (i.e., patents, inventions, models, or designs) would no longer be treated as a capital asset and the disposition would be treated as ordinary in character; and a separate provision would repeal the current rule that treats the sale or exchange of certain patents as long-term capital gain.

Pass-throughs

The House Bill includes the addition of a new income tax rate of 25% for individuals who own pass-through businesses. To the extent that an individual has taxable income that would otherwise be subject to a rate higher than 25%, any qualified business income (QBI) generally would be taxed at a 25% rate. QBI means, generally, all net business income from a passive business activity, plus the capital percentage of net business income from an active business activity, reduced by carryover business losses and by certain net business losses from the current year, as determined under the provisions in the House Bill.

Tax Alert 2017-1831 includes more information on: (a) identifying business activities, (b) determining income or loss, (c) separating passive and active activities, (d) identifying specified service activities, (e) determining the capital percentage, (f) determining the applicable percentage, and (g) determining the amount eligible for the QBI rate.

Other pass-through items that may be of interest to energy companies would include: (1) the repeal of partnership technical terminations caused by the sale or exchange of a 50% or more interest in the capital and profits of a partnership under Section 708(a)(1)(B) (the repeal would apply for partnership tax years beginning after December 31, 2017); (2) the repeal of the exclusion from self-employment tax for limited partners; and (3) certain rules related to the deductibility of interest expense.

International

The House Bill's major proposals for the international tax system include: (a) implementing a territorial tax system; (b) imposing a transition tax on accumulated foreign earnings; and (c) imposing anti-base erosion rules. Highlights include:

— *100% exemption for foreign-source dividends* — the House Bill would exempt 100% of the foreign-source portion of the dividends received by a US corporation from a foreign corporation in which the US corporation owns at least a 10% stake.

— *Repeal of investment in US property* — the House Bill would repeal the rules that taxed as dividends the investments made by certain foreign corporations in US property.

— *Limitation on losses with respect to 10%-owned foreign corporations* — Only for determining loss on the sale of stock of a 10%-owned foreign corporation, a US parent would reduce its basis in the stock of the foreign corporation equal to the amount of any exempt dividend it received from that foreign corporation.

— *Mandatory toll charge on tax-deferred foreign earnings* — A one-time transitional tax would be imposed on a US 10% shareholder's pro rata share of the foreign corporation's post-1986 tax-deferred earnings, at the rate of either 12% (in the case of accumulated earnings held in cash, cash equivalents or certain other short-term assets) or 5% (in the case of accumulated earnings invested in illiquid assets. A foreign corporation's post-1986 tax-deferred earnings would be the greater of those earnings as of November 2, 2017, or December 31, 2017. The US shareholder could elect to pay the transitional tax over a period of up to eight years.

— *Repeal of foreign base company oil-related income as subpart F income* — Foreign base company oil income would no longer be subject to immediate taxation in the United States.

— *Repeal of 30-day controlled foreign corporation (CFC) rules* — Foreign corporations would be considered CFCs as soon as the ownership requirements were met and subject to the subpart F and base erosion rules.

— *Anti-base-erosion provisions* — The House Bill would impose current US tax on 50% of a US shareholder's aggregate net CFC income (excluding certain items) in excess of extraordinary items from tangible assets. The extraordinary return base would equal 7%, plus the Federal short-term rate of the CFC's aggregate adjusted basis in depreciable tangible property, minus interest expense. Only 80% of the foreign taxes paid on the income would be allowed as a foreign tax credit.

— *Excise tax on payments to foreign affiliates* — The House Bill would subject all deductible payments, except interest paid to a related foreign company, to a 20% excise tax, unless the related foreign company elects to treat those payments as effectively connected income (ECI) and thus taxable in the United States. Further limitations would apply.

— *Foreign tax credit changes* — Indirect foreign tax credits would only be available for subpart F income.

— *Look-through rule for related CFCs made permanent* — The House Bill would make look-through provisions permanent for tax years of foreign corporations beginning after 2019.

Energy sector specific implications

Mining and Metals

The majority of mining and metals companies may be very pleased with what has been released in the House Bill. The bill provides for the repeal of the AMT — along with a mechanism to refund a company's balance of AMT credits over the next several years. Under the House Bill, the ability to claim percentage depletion for mining activities, combined with AMT repeal, would provide increased benefits for many sector companies.

Because of historic AMT adjustments related to percentage depletion and development costs, many mining and metals sector companies have been consistently subject to AMT and have large balances of AMT credits representing these prior year AMT payments. The repeal of the AMT would not only be a significant simplification for mining and metals companies, but would also enable them to more completely benefit from tax preferences created to encourage mining activities through the accelerated expensing of development costs and percentage depletion that would be retained under the House Bill. Similarly, the potential refunds of prior period AMT credits in tax years 2019-22 could allow many mining and metals companies to pay down debt or make new capital investments.

The mining and metals sector is particularly capital-intensive, with long payback periods for new capital projects. In this landscape, expanding the asset expensing provisions for 100% of qualified property while extending the term through 2022 to allow for the impact on actual capital decisions would be very beneficial and we would expect this to drive capital investment in the sector. On the other hand, limiting interest deductions to 30% of adjusted taxable income could significantly and adversely affect the after-tax cost of capital for investment decisions that could have been made several years ago. For many mining and metals companies, this limit on interest deductibility would be the largest negative effect of the House Bill.

While all the proposed international provisions would affect the mining and metals sector, no provisions appear to expressly single out the sector. The one provision that appears particularly interesting to mining and metals companies would be the proposed 20% excise tax on payments to foreign affiliate companies that do not elect to have these payments taxed as US ECI. Many global mining companies perform a variety of related-party cross-border technical services, as well as the cross-border transfer of minerals and metal products for either further beneficiation or sale. This would require companies with intercompany transactions of this type to quickly quantify the impact of these proposed rules on these flows, or alternatively consider modifying their procurement and sales to source products and services through unrelated parties.

Oil and gas

Similar to the mining and metals sector, oil and gas companies, on balance, may react somewhat favorably to the House Bill's business provisions. Perhaps most importantly for the oil and gas sector, several of its highest priorities - maintaining the deductibility of intangible drilling costs (IDCs), its eligibility to take percentage depletion, the ability to recovery certain geological and geophysical costs, and the designation of certain natural resource-related activities as generating qualifying income under the publicly traded partnership rules (PTP) were not touched.

As the oil and gas sector is also very capital intensive, and often needs many years to recoup necessary investments, expanding the 100% expensing provisions for five years ought to be effective for the deployment of capital and development of new projects. The oil and gas sector has a history of reinvestment and developing large scale operations that provide both economic growth and employment, and the 100% expensing provisions would appear to further that purpose.

Another potential benefit to oil and gas companies is the proposed repeal of AMT, coupled with the ability to obtain refunds of prior-period AMT credits. Given the nature of drilling programs and capital spending in the sector, many oil and gas companies have been in an AMT position and have carryover AMT credits. Eliminating the economic and administrative burden of the AMT, while allowing prior AMT credits to be potentially refunded, ought to be received positively by affected taxpayers. As previously noted, the oil and gas sector has historically re-deployed capital into new projects, and the repeal of the AMT and the credit provisions appear to further that purpose and ought to allow new, significant investments to be made.

On the other hand, the new provisions related to interest may be detrimental to oil and gas companies. The limitation on the deductibility of interest (which would generally not apply to regulated utilities, certain real property businesses, regulated gas pipelines, and certain other regulated assets) could negatively affect the after-tax cost of capital for investment decisions; those effects, however, ought to be modeled in connection with the 100% expensing, repeal of AMT, and other provisions to appropriately determine the true impact. Similarly, the elimination of the Section 199 deduction for certain domestic production activities may negatively affect certain oil and gas companies, particularly those in the downstream space. Also unfavorable to oil and gas companies, the House Bill would eliminate the carryback of specified liability losses, a provision that has been beneficial to an industry with large NOLs in the bonus depreciation years.

The House Bill's approach to oil and gas sector-specific tax incentives for conventional production is hit or miss: the enhanced oil recovery tax credit (Section 43) and the credit for producing oil and gas from marginal wells (Section 45I) are both proposed to be repealed (as they were previously, in the 2014 Camp bill). However, a number of provisions previously targeted in the 2014 Camp bill, including the Section 179C election to expense certain refineries; the passive activity exception for working interests in oil and gas wells; and the special rules for gain or loss on timber, coal, and domestic iron ore, were not addressed.

In the international tax section of the bill, the House Bill includes several oil-and-gas-specific provisions, including the proposed repeal of the foreign base company oil-related income rules. This proposal, which was not previously proposed in the Camp bill, would be effective for tax years of foreign corps beginning after 2017, and for tax years of US shareholders in which or with which such tax years of foreign subsidiaries end. Additionally, in the calculation of multinationals' one-time repatriation tax bill, recapture of foreign oil and gas losses was treated similarly to overall foreign losses, thus ensuring that the rules do not inadvertently discriminate against the oil and gas sector. Additionally, and as noted in the mining and metals sector implications section, the 20% excise tax, as well as the anti-deferral provisions and the one-time transition tax, could adversely affect certain oil and gas companies. Multinational oil and gas companies ought to quickly quantify the effects of these proposed rules on global operations and global payments and potentially consider modifying their procurement and sales to source products and services through unrelated parties. Finally, to the dismay of certain non-US investors, the Foreign Investment in Real Property Tax Rules do not appear to be altered under the House Bill.

Lastly, the House Bill appears to retain the working interest exception to the passive activity rules, and also appears to retain qualifying like-kind exchange treatment for certain investments in oil and gas reserves. The House Bill also contains a number of provisions related to pass-through activities, including the repeal of the technical termination rules under Section 708(b)(1)(B), which could affect joint venture relationships of oil and gas companies.

Power and utilities

The House Bill contains a number of provisions directly addressing power and utility companies. As capital-intensive businesses, power and utility companies are very interested in the immediate expensing provisions and the treatment of interest. With hundreds of millions of dollars invested in assets each year by the power and utilities industry, the treatment of the cost of capital is an economic factor on the minds of Treasurers and Chief Executive Officers. Unlike companies in most other industries, the debt-to-equity mix of regulated power and utility companies is already established and monitored at the state level.

The House Bill provides an exemption from the definition of qualified property for regulated power and utility companies, thereby forcing the use of the modified accelerated cost recovery system or an elective straight-line depreciation (under the alternative depreciation system). Most utility companies have historically used bonus depreciation and have amassed a large number of federal NOLs. The House Bill would permit these companies to start using their stockpile of NOL carryforwards. Conversely, the House Bill would eliminate the carryback of specified liability losses, a provision that has benefited an industry with large NOLs in the bonus depreciation years.

With large annual capital investments, an important issue to the power and utilities industry is the deductibility of net interest expense. Those regulated utilities ineligible for the proposed full expensing rules would be exempted from the net interest expense limitation rules. The House Bill defines business interest to exclude the interest paid or accrued on debt allocated to entities with rate-regulated revenue from electrical energy, water, sewage disposal, gas or steam through local distribution systems and gas or steam transported through pipelines. The House Bill does not provide a method of allocating interest to a rate-regulated entity, leaving a question as to whether a Section 861-type allocation method or perhaps a net book assets allocation method applies. Should this provision survive, further guidance would be needed.

Another provision included in the House Bill directly affecting power and utilities companies is the effect of the reduction in the overall tax rate on deferred taxes. The reduction in the tax rate would result in power and utility companies having excess accumulated deferred tax balances that would need to be passed on to customers in accordance with current normalization rules. The House Bill sets forth the average rate assumption method (ARAM) to pass the benefit of the lower tax rate and reduction in deferred tax liabilities to customers over the remaining regulatory life of the utility property. The House Bill does permit a simplified alternative method if information is not available to compute the ARAM method.

Few power and utility companies have international operations, but those with CFCs with non-previously taxed unremitted earnings and profits would incur the one-time tax on tax-deferred earnings. For those companies with previous foreign-source income limitations due to Section 861 allocations, the ability to use foreign tax credit carryforwards against this tax is a benefit. Finally, the repeal of Section 956, requiring immediate income recognition for loans or other investment in US property, such as stock of the US entity, is well-received among power and utility companies with foreign operations, as is the 100% exemption of foreign-source dividends paid by a CFC.

Renewable and alternative energy

The House Bill contains a number of provisions related to renewable and alternative energy, many of which could affect companies either currently investing and operating in the space or currently considering making such investments.

The House Bill proposes major retroactive changes to the Section 45 production tax credit (PTC) for electricity produced from renewable resources. The inflation adjustment, under which the base credit amount of 1.5 cents per kilowatt hour has risen with inflation to 2.4 cents, would be repealed, effective for electricity and refined coal produced at a facility whose construction begins after the House Bill's enactment date. The statutory language provides that the reduction in the credit rate would apply only to facilities that begin construction after the date of enactment, but the section-by-section analysis accompanying the House Bill indicates that a "taxpayers' credit amount would revert to 1.5 cents per kilowatt hour for the remaining portion of the 10-year period," which implies that the change would also apply to electricity produced at existing facilities. Subsequent signals from the committee confirm that the termination of the inflation adjustment is intended to apply to qualified facilities whose construction begins after the House Bill's enactment date.

The House Bill would also alter the current IRS guidance for qualification of when construction begins on a qualified facility. There are currently two methods by which a taxpayer can establish that construction has begun — a physical work test and a 5% safe harbor. The methods require the taxpayer to satisfy a continuous construction or continuous efforts requirement, respectively. Under guidance issued by the Internal Revenue Service in 2016 (Notice 2016-31), if a taxpayer places a facility in service during a calendar year that is no more than four calendar years after the calendar year during which construction of the facility began, the facility will be deemed to have satisfied the continuous construction requirements.

The House Bill would overturn that guidance and provides instead that the construction of any facility, modification, improvement, addition or other property may not be treated as beginning before any date unless there is a continuous program of construction beginning before such date and ending on the date that such property is placed in service. This clarification would apply to tax years beginning before, on or after the date that the House Bill is enacted into law.

The House Bill leaves largely intact the investment tax credit (ITC) provisions for both residential and commercial solar property that were enacted in 2015, preserving the 30% ITC for solar energy property whose construction begins before 2020, phasing down to 26% for solar property whose construction begins before 2021 and to 22% for projects beginning construction before 2022. For the residential solar credit under Section 25D, the credit would expire at the end of 2021. For the commercial ITC under Section 48, a permanent 10% ITC would be available for solar property whose construction begins after 2021. In a noticeable departure from the 2015 agreement, the House Bill would eliminate the 10% ITC for property whose construction begins after 2027.

The House Bill would also extend the Section 48 investment tax credit to technologies that were left out of the 2015 PATH Act, namely fiber-optic solar property, geothermal energy, fuel cells, microturbines, combined heat and power systems, and small wind systems. The expiration dates and phase-out schedules for these technologies would be harmonized with the solar ITC. Accordingly, fiber-optic solar energy, qualified fuel cell, and qualified small wind energy property would receive a 30% ITC for property whose construction begins before 2020, 26% for property whose construction begins before 2021, and 22% for property whose construction begins before 2022. No ITC would be available for property whose construction begins after 2021. Additionally, the 10% ITC for qualified microturbine, combined heat and power system, and thermal energy property would be available for property whose construction begins before 2022.

The Section 25D residential energy efficiency credit likewise would be extended and phased out for other technologies that were omitted from the 2015 PATH Act, including qualified geothermal heat pump property, qualified small wind property and qualified fuel cell power plants. These particular amendments would apply to property placed in service after 2016.

Finally, the House Bill would clarify that the construction of any solar facility, modification, improvement, addition, or other property may not be treated as beginning before any date unless there is a continuous program of construction which begins before such date and ends on the date that such property is placed in service. This clarification would apply to tax years beginning before, on, or after the date of the House Bill's enactment.

The House Bill fails to extend a number of other temporary tax incentives for renewable energy. On December 31, 2016, provisions aimed at stimulating both renewable baseload electricity facility development, and advanced biofuel production, expired. Technologies affected by the electricity credit expiration include hydropower; biomass and waste to energy. Biofuel companies still hoping for an extension of their expired incentives include biodiesel; renewable diesel; alternative fuels and second generation biofuels.

Conclusion

While the potential effects of the Tax Cuts and Jobs Act will vary across the domestic energy sector on a company-by-company basis, at first glance, we think the bill could drive economic growth and foster energy development. The energy sector is very capital-intensive, and has a history of re-deploying capital and earnings into new projects, driving economic activity and employment. Chairman Brady's proposal appears to support and encourage companies to continue to make significant investments in the United States. That being said, a number of provisions, including those related to interest expense limitations, those affecting inbound energy investments, and those related to the taxation of foreign income and foreign persons, will require further analysis.

Next steps

The House Bill will be the subject of Committee consideration, kicking off formal tax committee action on the first such overhaul of the US federal tax system in over 30 years. Separately, Senate Finance Committee Chairman Orrin Hatch (R-UT) announced that he plans to release a Senate Republican version of a tax reform bill after the Ways and Means Committee completes its work.

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ENDNOTES

[1] Subsequently, on November 3, 2017, Chairman Brady released an Amendment in the Nature of a Substitute to H.R. 1 (collectively with the original version of H.R. 1, the House Bill). The same day, the staff of the Joint Committee on Taxation released a "Description of H.R. 1, The 'Tax Cuts and Jobs Act,'" which provides for additional commentary around the House Bill.