Tax Reform Overview for Oil & Gas Companies & Investors

Presented by:
Lori Mettille

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Background

How we got here

House & Senate

Introduced bills in November

House passed its bill Nov 9

Senate passed its bill Dec 2

Conference

Conferees released Conference Agreement Dec 15

Senate and House voted and passed on Dec 20

President

President Trump signed Tax Cuts and Jobs Act (TCJA) into law on Dec 22

Highlights for the O&G Industry

- IDC and percentage depletion deductions remain
- Corporate rate reduced from 35% to 21 %
- New deduction for pass-through income
- Corporate AMT repealed
  - 59(e) election appears to remain
  - AMT credits become refundable
- Increased expensing for tangible property

Business Provisions

Business Provisions

Provision	Pre-Reform Law	Reform Act
Corporate Income Tax Rate	35% top rate	21% flat rate; effective 1/1/2018; blended rate for fiscal taxpayers
Corporate AMT	Applies	Repealed
Dividends Received Deduction	• 70% if own <20% • 80% if own between 20% and 80% • 100% if own more than 80%	• 50% if own <20% • 65% if own between 20% and 80% • 100% if own more than 80%

Net Operating Loss

Limited to 80% - Carried Forward Indefinitely

Limited to 80% of taxable income for NOLs arising in years beginning after December 31, 2017

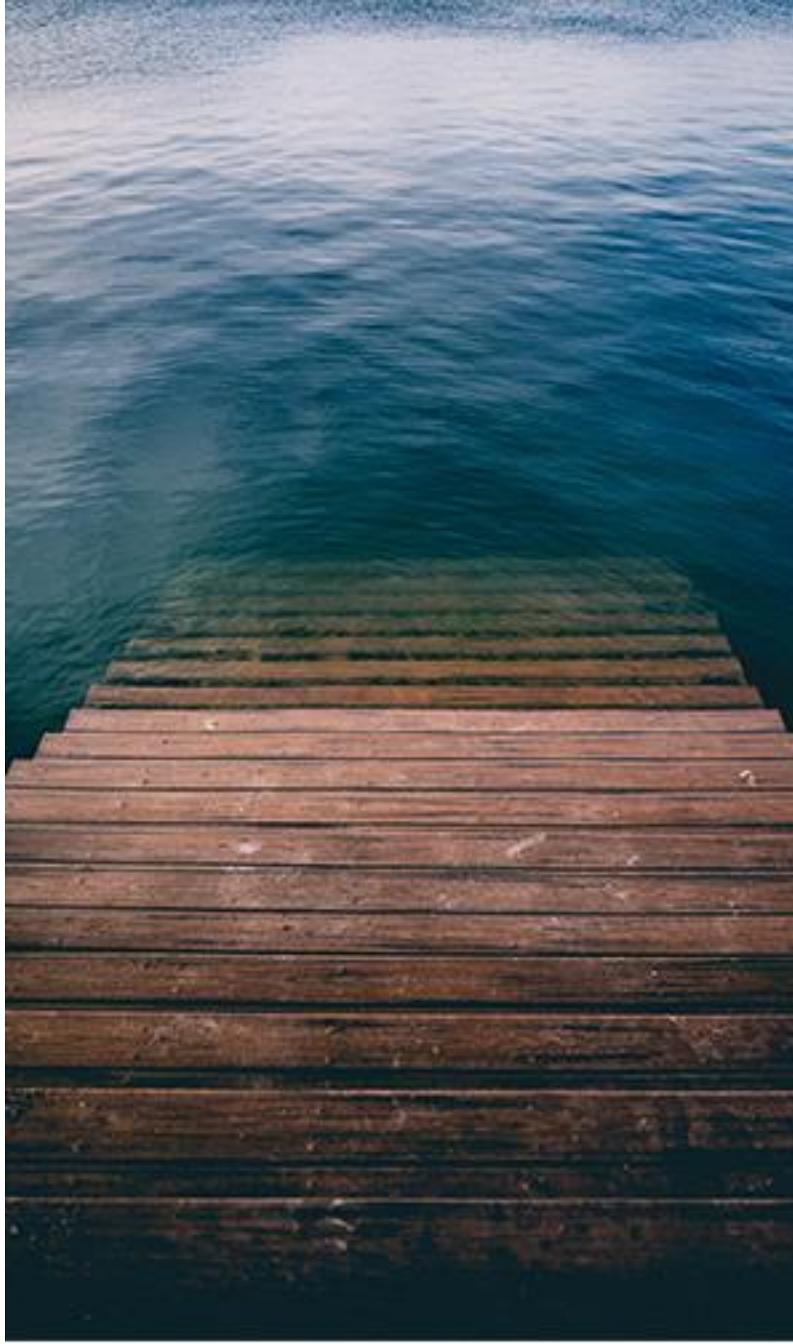
Carryforward period made indefinite, no carryback (except farms) for years ending after December 31, 2017

Prior law - Specified liability loss extended carryback period

Reform Act – Carryback of all losses disallowed

Alternative Minimum Tax

- The Tax Cuts and Jobs Act repeals AMT for corporations in 2018.
- AMT credit is able to offset regular tax liability for any taxable year.
  - Refundable between 2018 and 2020 for up to 50% (100% in 2021) to the extent AMT carryovers exceed the regular tax liability.
  - May be subject to 6.6% reduction for sequestration under Budget Control Act of 2011
- IRC §59(e) has not been repealed



Executive Compensation

- The rules under IRC §162(m) modified as follows:
  - Performance-based and commission exceptions to $1 million deduction repealed
  - Expanded definition of applicable employer to include entities that are issuers required to file under Section 15(d) of Exchange Act
  - Definition of covered employee revised to include:
    - Principal financial officer
    - All individuals who hold title of Principal Executive Officer or Principal Financial Officer at any time during year
    - Three-highest paid officers outside of principal executive officer or principal financial officer whose compensation requires disclosure to investors (conforms statute to IRS Notice 2007-49)
  - Covered employees after December 31, 2016 remain covered employees for all subsequent taxable years, including years after death

Business Interest Deduction

Limited to sum of:

1) 30% of “adjusted taxable income”
2) Business interest income
3) Floor plan financing interest

- Interest limited is carried forward indefinitely
- Adjusted taxable income:
  - Cannot be below zero
  - Computed without regard to:
    - Non-business income or expenses
    - Business interest expense or income
    - NOL deduction
    - Pass-through deduction
    - For years before 2022, deductions for depreciation, amortization, and depletion
- Businesses with average gross receipts of $25M or less would be exempt

Bonus Depreciation

Bonus deprecation is increased to 100% for qualified property acquired and placed in service after Sept 27, 2017 but before Jan 1, 2023

- **Pre-reform law:** Bonus depreciation set at 50% for 2017 – 40% for 2018 – 30% for 2019
- **Qualified property includes:**
  - New *and used* property, but must be in an arm's length transaction
  - Film, television, and live theatrical productions
- **Phase-outs:** Bonus percentage decreases to 80% for 2023 – 60% for 2024 – 40% for 2025 – 20% for 2026 – None for 2027

Section 179

Section 179 Deduction Expanded

- Increases the amount a taxpayer may expense to $1,000,000 (from $510,000 for 2017) and increases the phase-out threshold to $2,500,000 (from $2,030,000 for 2017)
- Expands eligibility of Section 179 to include:
  - Qualified improvement property (QIP)
  - Certain nonresidential real property improvements – specifically, roofs; heating, ventilation, and air-conditioning (HVAC) property; fire protection and alarm systems; and security systems
  - Personal property used predominantly in lodging

Like-Kind Exchanges

Limited to Real Property

- Applies only to real property not held primarily for sale
  - Operating and nonoperating mineral interests expected to continue to qualify
  - Tangible well equipment, facilities, etc. will not qualify

Fringe Benefits and Entertainment Expenses

Provision	Pre-Reform Law	Reform Act
Entertainment or Recreation Expenses	50% deductible to the extent directly related to, or associated with, an active conduct of a trade or business	Repealed – no deduction allowed for expenses even if directly connected to the business (meals still 50% deductible)
Food and Beverage Expenses for Employees (On-site Cafeteria or De Minimis Meals)	100% deductible, if considered a de minimis fringe benefit	50% deductible if de minimis and for convenience of employer – **after 2025**, expenses related to on-site cafeteria not deductible
Moving Expenses (Non-military)	Reimbursements excluded from employee wages	Suspends exclusion for 2018 through 2025

Research & Development Expenditures

- Beginning in 2022, specified U.S. research expenses must be capitalized and amortized ratably over five years.
- Expenses attributable to research conducted outside the U.S. are amortized over 15 years.
- Specified expenses do not include expenditures for land or depreciable property, but do include related depreciation allowances.
- If property is disposed, retired, or abandoned during the amortization period, basis is not recovered – must continue to be amortized over remainder of the period.
- Application is treated as a Sec. 481 change of accounting method.

Other Provisions

- DPAD is repealed for tax years beginning after 2017
- Broad changes for multinational companies with shift to a territorial tax regime
- Mandatory deemed repatriation of undistributed foreign earnings

Partnership Changes

- After 2017, the basis limitation on the deductibility of partnership losses applies to a partner's distributive share of charitable contributions and foreign taxes
- Repeal of technical termination rules:
  - A partnership is treated as continuing even if more than 50% of interests are sold or exchanged.
- Substantial Built-In Loss:
  - Definition expanded to include a partner-level test – if any partner would be allocated more than a $250,000 loss in a hypothetical disposition of all assets, the partnership is considered to have a substantial built-in loss.

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Individual/Investor Provisions

Highlights

- Lowers tax rate for most taxpayers (some single taxpayers will pay more)
- Limits or eliminates some deductions and credits, but expands others
- Many changes will cease to apply after 2025 and revert back to pre-2018 law

Income Brackets & Tax Rates

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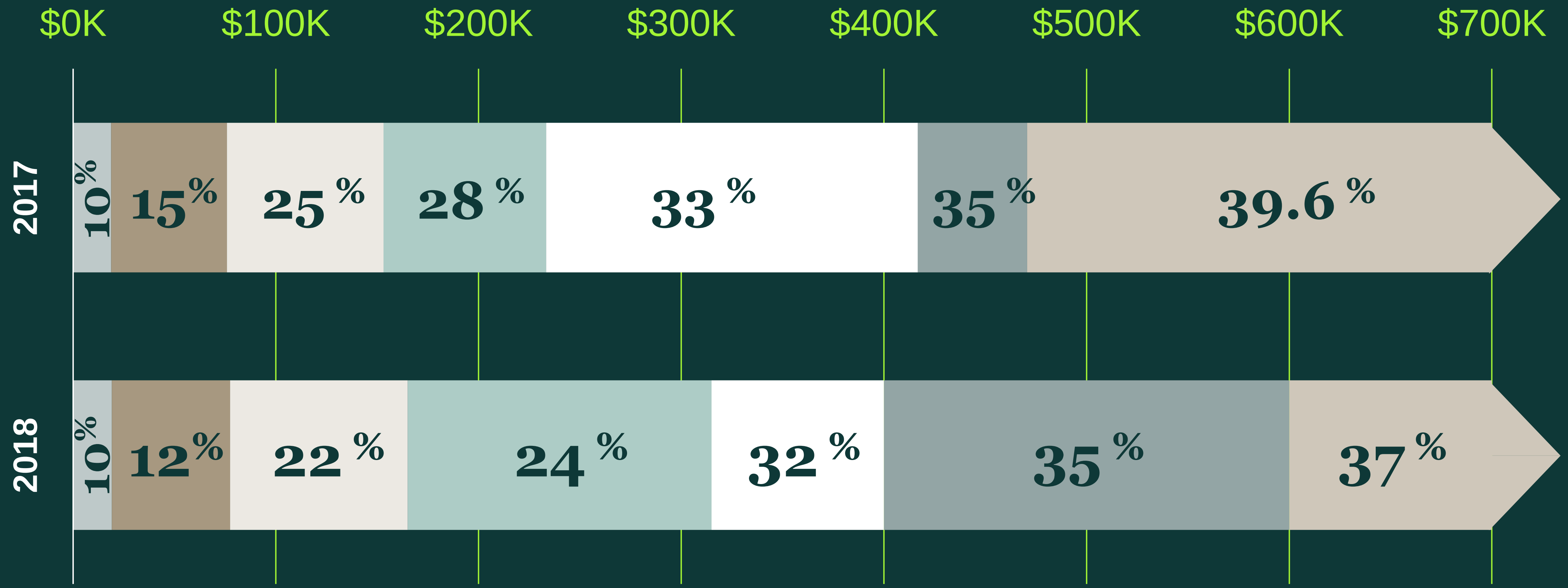

Income Brackets & Tax Rates

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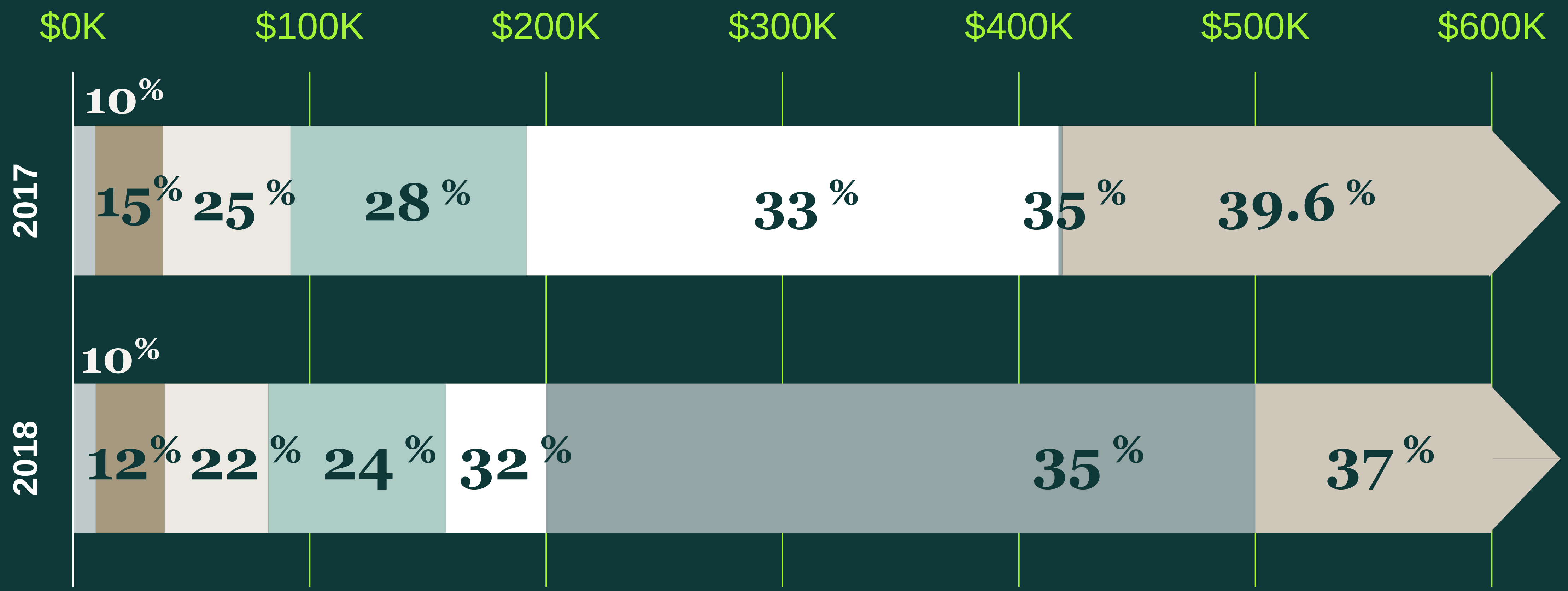

Passthrough Income

Allows 20% deduction of "qualified business income" (QBI) – Sunsets in 2026

- QBI is qualified income, gain, deduction and loss from a partnership, S corporation, or sole proprietorship.
  - Does not include reasonable compensation paid to a shareholder or partner.
- Does not include "specified service trade or business" income
  - Law, health, consulting, financial services, or any trade or business where the principal asset is the reputation or skill of one or more of its owners or employees (excluding engineering and architecture).
  - <u>Exception:</u> Specified service trade or business exemption if taxable income does not exceed the "threshold amount" of $315K (MFJ)/$157.5K (other), phased out over the next $100K.

20% Deduction on Qualified Business Income - Section 199A

Qualified Business

- Must be a "trade or business"
- Certain services are excluded*
- Performing services as employee excluded

Qualified Business Income

- Income that is "effectively connected" to a trade or business in US
- Certain investment items excluded (including capital gains)
- Compensation excluded
- Special loss recapture rule

W-2 and Property Limitations

- Limitation applies if 20% of qualified trade or business income exceeds:**
- (A) 50% of W-2 wages; or
- (B) 25% of W-2 wages and 2.5% of "qualified property"

Taxable Income Limitations

- Deduction cannot exceed 20% of taxable income (less net capital gain)

**Service business may be treated as qualified business if taxpayer's income is under certain threshold amounts

** Limitation does not apply if taxpayer's income is under certain threshold amounts. Importantly, the limitations apply on a business-by-business basis.

- Qualified cooperative dividends, qualified REIT dividends, and qualified publicly traded partnership income also qualify for the section 199A deduction

Pass-through Income Limitation

- Limitation is phased-in from $315K-$415K (MFJ)
  - For those with taxable income in excess of $415,000 (MFJ) the deduction is limited to the greater of:
    - 50% of W-2 wages or,
    - Sum of 25% of W-2 wages plus 2.5% of the unadjusted basis of all qualified property

New Loss Limitation Rules - Section 461(l)

- Rule: Non-corporate taxpayer cannot deduct an "excess business loss"
- Excess Business Loss: Effectively, equals a taxpayer's net loss from all trades or businesses in excess of $500,000 (married) or $250,000 (other)
- NOL Treatment: Excess business loss becomes treated as an NOL in subsequent year
- Relationship to Other Loss Limitation Rules: The excess business loss rule applies after other loss limitation rules (e.g., basis limitations, "at risk" rules, passive activity rules)
- Result: Business losses in excess of $500,000 (married) or $250,000 (other) cannot offset non-business income in the year incurred. Suspended losses can be used in subsequent years subject to the 80% taxable income limitation

Carried Interest

Holding Period

- Adds holding period requirement of **3 years** for IRC §1222 gains on carried interest in investment or development of specified assets

- May not apply to operating interests
  - Natural resource development and production of operating interests not listed as a specified asset
  - Sale of operating mineral interests would produce IRC §§1231 and 1254 gains, not IRC §1222 gains

Wrap Up

Next Steps

- Address tax accounting impacts for financial reporting
- Evaluate 2017 accounting methods to obtain permanent benefit before rate decrease in 2018
- Model effect of legislation to understand how it impacts your business
- Consider entity conversions and/or investment vehicles going forward, particularly upon sunset of 20% pass-through deduction
- Review executive compensation programs
- Monitor state responses to Tax Reform Act

Contact Information

Lori Mettille
Tax Partner

Lori.Mettille@mossadams.com

(972) 458-2296