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AN UPDATE ON TAX REFORM AND ITS IMPLICATIONS IN 2018

Energy Series

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Wednesday, March 21, 2018

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DISCUSSION TOPICS

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TAX CUTS AND JOBS ACT UPDATE
OVERVIEW

- **Public Law 115-97**
  - *An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018*
  - Generally referred to as the Tax Cuts and Jobs Act (TCJA)
- **Rapid Time to Passage**
  - House Ways & Means Committee Chairman Kevin Brady releases Chairman's Mark in bill form November 2, 2017. Committee marks up Nov. 6-9; files Committee Report Nov. 13. House passes HR 1 Nov. 16, 227-205.
  - Senate Finance Committee Chairman Orrin Hatch releases his Chairman's mark November 9. Committee marks up Nov. 13-16. Starting Nov. 29, Senate takes up HR 1 and debates McConnell/Hatch Amendment, with passage of amended bill December 2, on party-line vote, 51-49.
  - House appoints conferees Dec. 4; Senate follows Dec. 7. Conferees meet formally Dec. 13. Conference Report filed December 15; adopted by House Dec. 19, 227-203. On Dec. 20, Senate amends House-passed version of HR 1, 51-48. House then agrees to the bill as amended. Bill is enrolled and sent to President Dec. 21.
  - Date of enactment: December 22, 2017

TCJA TIMELINE

Nov 2

House W&M Committee Chairman releases mark for H.R.1, the Tax Cuts and Jobs Act

Nov 16

House passes H.R. 1

Senate Finance Committee agrees to amended version of H.R. 1

Dec 2

Senate passes H.R. 1 with additional amendments

Dec 15

House and Senate conferees file Conference Report

Dec 19

House adopts TCJA Conference Report

Dec 20

Senate amends House-passed bill

House agrees to bill as amended

Dec 22

President signs H.R. 1, Public Law 115-97

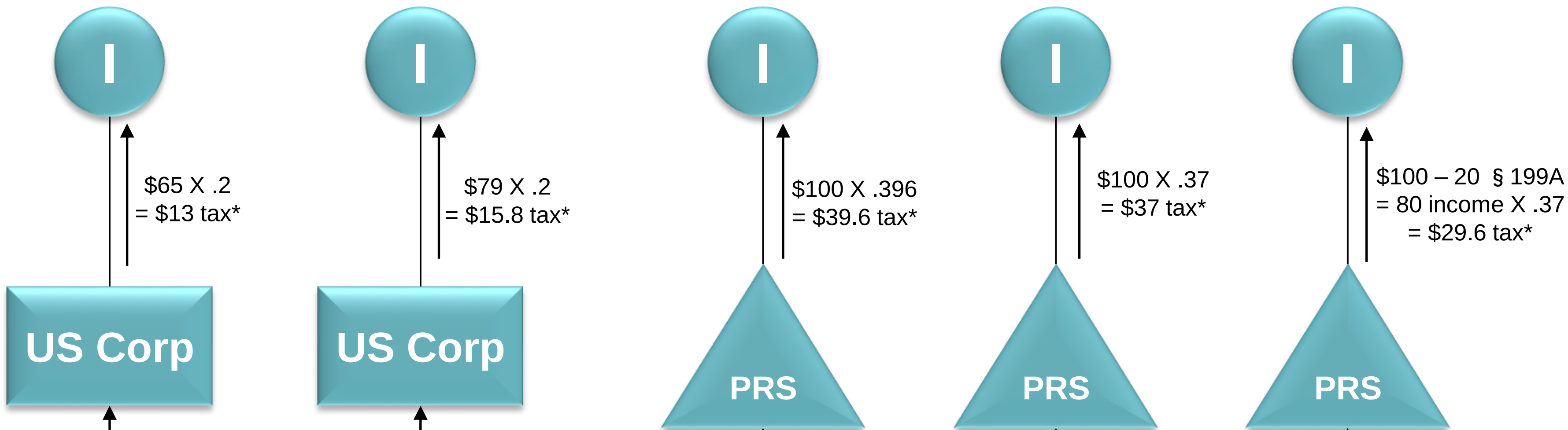
TAX CUTS AND JOBS ACT UPDATE
IMPLEMENTATION

- **Regulations, IRS Notices and Other Guidance**
  - Treasury released an update to the Priority Guidance Plan on February 7, 2018.
  - Plan includes 18 additional projects identified as “near term priorities” as a result of the TCJA.
  - Treasury invites public comments and suggestions on these and other TCJA items.
  - Officials have said they intend to release listed priority TCJA guidance by June 30.
  - Key TCJA issues identified:
    - computational, definitional, and anti-avoidance guidance for pass-through businesses under new § 199A
    - guidance implementing new § 965 repatriation and other international sections (Notices 2018-07; 2018-13)
    - guidance under new § 1446(f) for withholding on sales of certain MLP interests (Notice 2018-08)
    - guidance on expensing under § 168(k)
    - computational, definitional and other guidance for new limits on interest deductions under § 163(j)
- **Bipartisan Budget Act of 2018**
  - Provides one-year extension of expired energy tax provisions from S. 2256, a bill introduced by Chairman Hatch on December 20, 2017. Also includes minor changes to TCJA. Sets March 23 deadline for spending measures.

TAX CUTS AND JOBS ACT UPDATE
IMPLEMENTATION

- **Blue Book**
  - Prepared by the staff of the Joint Committee on Taxation (JCT).
  - Where technical explanations contemporaneous with legislation were prepared and published by the JCT staff, the Blue Book will follow these explanations.
- **Technical Corrections Legislation**
  - Technical corrections address drafting errors in specific statutory provisions to reflect original Congressional intent.
  - Traditionally, to be included in a technical corrections bill, a proposed correction must receive sign-off from majority and minority staff of the House and Senate tax-writing committees, and from JCT staff, that the proposed correction meets these requirements. Treasury concurrence also may be sought.
  - True technical corrections have no revenue impact, as they merely correct prior legislation that already has been scored for budget purposes.
  - In the past, the chairmen and ranking members of the tax-writing committees jointly introduce a package of technical corrections in bill form, even when prompt enactment is not certain. This can assure taxpayers and the IRS as to how Congress intended to have various provisions interpreted. Substantial delay in enactment can prove problematic.

TAXATION OF DOMESTIC BUSINESS INCOME BEFORE AND AFTER TCJA



Corporations		Pass-Throughs		
Pre-TCJA	Post-TCJA	Pre-TCJA	Post-TCJA w/out § 199A	Post-TCJA w/ § 199A
$100 income X .35 = $35 tax	$100 income X .21 = $21 tax	$100 income X 0 = $0 tax	$100 income X 0 = $0 tax	$100 income X 0 = $0 tax
Tax on $100 = 48%	Tax on $100 = 36.8%	Tax on $100 = 39.6%	Tax on $100 = 37%	Tax on $100 = 29.6%

*Ignores 3.8% Net Investment Income Tax: individual rates revert to pre-TCJA rates in 2026

CARRIED INTEREST
DEFINITION OF CARRIED INTEREST

- **Definition of Carried Interest**
  - An interest in a partnership
  - that is received in connection with the performance of substantial services
  - in an "***applicable trade or business***"

- **Applicable Trade or Business**
  - An activity conducted on a regular, continuous, and substantial basis that consists, in whole or in part, of:
    - Raising or returning capital, ***and***
    - Investing in, disposing of or developing "***specified assets***"

- **Specified Assets**
  - Stock in a corporation, an interest in a publicly traded partnership, most debt instruments, and certain notional principal contracts
  - Commodities
  - Real estate held for rental or investment
  - Cash or cash equivalents
  - Options or derivative contracts with respect to any of the foregoing, and
  - An interest in a partnership to the extent of the partnership's proportionate interest in any of the foregoing

DEFINITION OF CARRIED INTEREST

- **Exclusions From Carried Interest**
  - Does not apply to a capital interest, which provides a right to share in partnership capital commensurate with the amount of capital contributed (e.g., capital invested by general partner or portfolio company management)
  - Under regulations to be promulgated, carried interest rules do not apply to income attributable to assets not held for portfolio investment on behalf of "third party investors"
  - Does not apply to an interest held by a corporation

EFFECT ON CARRIED INTEREST

- Long-term capital gain with respect to an affected carried interest is determined by substituting a 3 year holding period in lieu of a 1 year holding period
  – Statutory provision is not clear on whether the longer holding period applies to the carried interest, the capital asset being sold by the underlying partnership or both. Presumably, at least to the capital asset sold
  – Holding period of carried interest is based on when interest is issued
  – Holding period of assets is based on when the assets were acquired and placed in service

AVOIDING CARRIED INTEREST RULES

- Do not invest in, dispose of or develop "specified assets"
  - Avoid corporate portfolio companies or subsidiaries
- Do not "raise or return capital" on a regular, continuous and/or substantial basis
- Do not take investments from "third party investors"
  - "Third party investors" are persons who do not hold their partnership interest in connection with an applicable trade or business and do not provide substantial services to the partnership
- Do not sell "capital assets"
  - Gain from the sale of "1231 assets" may not be impacted
  - 1231 assets are depreciable or real property used in a business and held for more than one year
  - Goodwill and other self-created intangibles are capital assets
- Hold carried interest through a corporation

PASSTHROUGH BUSINESS DEDUCTION
GENERALLY

- Individual deduction of 20% of certain types of income earned by pass-through businesses, subject to limitations.
- Below the line deduction
- Top modified individual effective tax rate is 29.6%
- Applies to income earned by sole proprietorships, partnerships, S corporations, REITs, MLPs, cooperatives, estates and trusts.
- Deduction sunsets after 2025

PASSTHROUGH BUSINESS DEDUCTION
INCOME ELIGIBLE FOR INCLUSION IN DEDUCTION CALCULATION

- Deduction is equal to 20% of the sum of:
  - Qualified Business Income (QBI)
  - Qualified Cooperative Dividends
  - Qualified REIT Dividends
  - Qualified PTP Income

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PASSTHROUGH BUSINESS DEDUCTION
QBI – GENERAL TREATMENT

- Qualified Business Income (QBI)
  - Net amount of effectively connected items of income, gain, deduction, and loss with respect to a taxpayer's qualified trade or business (to the extent such items are included or allowed in the determination of taxable income for the year).
  - If Net QBI is a loss, it is carried forward and treated as a loss from a qualified business in the next tax year.
  - The amount of deduction arising from QBI may be limited in several instances as described in the following slides.
  - Net QBI is determined separately for each qualified trade or business of the taxpayer.

PASSTHROUGH BUSINESS DEDUCTION
LIMITATIONS ON QBI: EXCLUDED TYPES OF INCOME

- QBI does not include
  - Specified types of investment income:
    - (i) items taken into account for purposes of determining net long or short-term capital gain/losses;
    - (ii) dividends; or
    - (iii) other specified investment-related income, deductions or losses.

      Long-term capital gains and dividends continued to be taxed at 20%
  - Salaries that are "reasonable compensation";
  - Guaranteed payments for services; or
  - Payments to partners for services rendered with respect to the trade or business.

PASSTHROUGH BUSINESS DEDUCTION
LIMITATIONS ON QBI: SPECIFIED TRADE OR BUSINESS

- Income from a "specified trade or business" is phased out of inclusion in QBI for taxpayers with taxable income above an indexed threshold.
  - Specified trade or business
    - Professional service business (i.e., health, law, consulting but excluding engineering and architecture);
    - Any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners; or
    - Services that consist of investing and investment management trading, or dealing in securities, partnership interests, or commodities.

PASSTHROUGH BUSINESS DEDUCTION
LIMITATIONS ON QBI: WAGE LIMIT

- QBI deduction may be reduced below 20% for taxpayers with taxable income above an indexed threshold.
  - "Wage limit," if applicable, limits deductible QBI amount to the greater of
    - 50% of a taxpayer's share of W-2 wages paid by the business to its employees or
    - 25% of a taxpayer's share of W-2 wages plus 2.5% of the unadjusted basis of depreciable tangible property that is held and used by business in the production of QBI.
  - Applicable to taxpayers with taxable income above $207.5K ($415K for joint filers).
  - Taxpayers with taxable income in the "phase-in range" ($50k ($100k for joint filers)) are subject to proportionate reduction rules.

PASSTHROUGH BUSINESS DEDUCTION
QUALIFIED REIT DIVIDENDS

- Qualified REIT Dividends
  - Any REIT dividend that is not treated as:
    - A capital gain dividend (Section 857(b)(3))
    - Qualified dividend income (Section 1(h)(11))
- Not subject to the QBI wage limitation

PASSTHROUGH BUSINESS DEDUCTION
QUALIFIED PTP INCOME

- Qualified PTP Income
  - Sum of:
    - Qualified trade or business income from a PTP
      - Based on the same concepts as QBI
      - Not related to “qualifying income” under Section 7704(d)
    - Recapture upon sale of PTP interest (Section 751(a))
      - Recapture on sale of non-PTPs is not addressed
- Not subject to the QBI wage limitation

IMPACT TO MLPS

- MLPs retain their status as publicly traded partnerships
  – No change to qualifying income exception
- MLP income eligible for 20% deduction of qualifying business income
  – Deduction expires after December 31, 2025
  – Applies to MLP's recapture income
  – Qualified business income wage limitation does not apply
- With effective top rate for MLP income of 29.6%, MLPs retain an "all in" effective tax rate benefit over C-Corps on distributed earnings
  – Tax rate benefit is 7.2% (previously 8.4%)
- Deduction for state and local taxes is limited to $10,000
- 10% withholding on sale of a partnership interest that is treated as "effectively connected income"
  – Brokers, rather than the MLP, may be responsible for withholding

§ 163(j) INTEREST DEDUCTION LIMITATION
FORMULA

- Deduction for "Business Interest" limited to sum of:
  - "Business Interest Income", plus
  - 30% of "Adjusted Taxable Income", plus
  - Floor Plan Financing Interest
- Carry Forward Rule
  - Business interest subject to limitation carried forward as business interest indefinitely
- Application to Consolidated Groups
  - Per legislative history "limitation applies at the consolidated tax return filing level"

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§ 163(j) INTEREST DEDUCTION LIMITATION

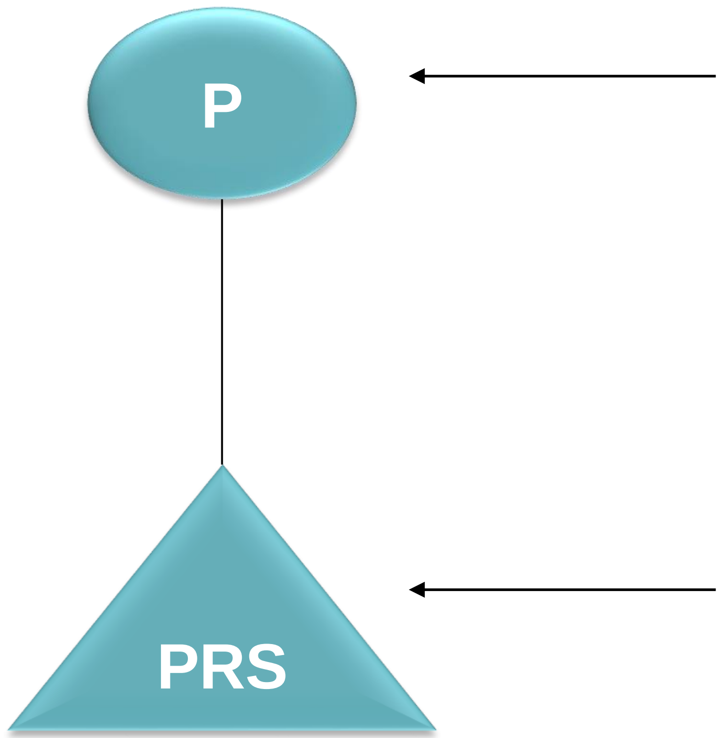
DEFINITIONS

- Business Interest
  - Interest paid or accrued on indebtedness properly allocable to a trade or business (§ 1.163-8T?)
  - Excludes § 163(d) “investment interest”
    - Per legislative history, all corporate interest expense is business interest
  - Trade or business does not include furnishing or sale of
    - Electrical energy, water, or sewage disposal
    - Gas or stream through a local distribution system, or
    - Transportation of gas or steam by pipeline
      - In each case, if rates are regulated

§ 163(j) INTEREST DEDUCTION LIMITATION
DEFINITIONS

- Business Interest Income
  - Interest income includible in gross income which is <u>properly allocable</u> to a trade or business (§ 1.163-8T?)
  - § 163(d) investment interest income is excluded
  - Per legislative history, all corporate interest income is business interest income
- Adjusted Taxable Income
  - Through 2021
    - Taxable business income (excluding business interest and business interest income), exclusive of depreciation, amortization or depletion (taxable business “EBITDA”)
  - Post 2021
    - Same, but including depreciation, amortization and depletion (taxable business “EBIT”)

§ 163(j) INTEREST DEDUCTION LIMITATION
APPLICATION TO PARTNERSHIPS & S CORPORATIONS



- Interest deductions disallowed to PRS allocated to partners and carried forward at partner level
  - Only available to deduct against future excess taxable income of PRS
- "Excess Taxable Income" available as adjusted taxable income of partner
  - Roughly equal to excess available adjusted taxable income capacity at partnership level
- Apply limitation first at partnership level
  - Interest deductions allowed lose character as interest deductions
  - Treated as non-separately stated income

TCJA § 168(k)
100% EXPENSING OF NEW & USED TANGIBLE PROPERTY

- New § 168(k) "Bonus Depreciation"
  - 100% expensing for investment in new *or used* tangible property acquired and placed in service after September 27, 2017 through 2022
  - Declining 20% per year through 2027
  - Used Property Limitations ("Acquisition Requirements")
    - Property not used by taxpayer any time prior to acquisition
    - Not acquired from a related person
    - Not acquired in a carryover basis transaction

TAX REFORM IMPACT ON ASSET VALUATION
PRE-TAX REFORM

Pre-Tax Cash Flows	Inception	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Total
Purchase Price	**(400.00)**							(400.00)
Revenues		100.00	100.00	100.00	100.00	100.00	100.00	600.00
Pre-Tax Cash Flow	(400.00)	100.00	100.00	100.00	100.00	100.00	100.00	200.00

After-Tax Cash Flows								
Revenues		100.00	100.00	100.00	100.00	100.00	100.00	600.00
Cost Recovery		(80.00)	(80.00)	(80.00)	(80.00)	(80.00)		(400.00)
Taxable Income		20.00	20.00	20.00	20.00	20.00	100.00	200.00
Taxes Paid		(7.00)	(7.00)	(7.00)	(7.00)	(7.00)	(35.00)	(70.00)
After-Tax Cash Flows	(400.00)	93.00	93.00	93.00	93.00	93.00	65.00	130.00
After-Tax IRR	9.04%							

TAX REFORM IMPACT ON ASSET VALUATION
POST-TAX REFORM

Pre-Tax Cash Flows	Inception	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Total
Purchase Price	**(438.35)**							(438.35)
Revenues		100.00	100.00	100.00	100.00	100.00	100.00	600.00
Pre-Tax Cash Flow	(438.35)	100.00	100.00	100.00	100.00	100.00	100.00	161.65

After-Tax Cash Flows								
Revenues		100.00	100.00	100.00	100.00	100.00	100.00	600.00
Cost Recovery		(438.35)						(438.35)
Taxable Income		(338.35)	100.00	100.00	100.00	100.00	100.00	161.65
Taxes Paid		71.05	(21.00)	(21.00)	(21.00)	(21.00)	(21.00)	(33.95)
After-Tax Cash Flows	(438.35)	171.05	79.00	79.00	79.00	79.00	79.00	127.70
After-Tax IRR	9.04%							

Change in Asset Purchase Price $	**38.35**
Change in Asset Purchase Price %	**9.59%**

NOLS, TECH TERMS, EXCESS BUSINESS LOSSES, LKE

- Net Operating Loss (NOL) Limitation (Section 172)
  - NOL deduction for losses arising in taxable years beginning after Dec. 31, 2017 is limited to 80% of taxable income (determined without regard to the deduction)
  - Generally, NOLs can no longer be carried back to each of the prior 2 taxable years
  - However, NOLs can now be carried forward indefinitely
  - NOLs from prior to 2018 are not subject to 20% limitation
- Excess Business Losses
  - An excess business loss is the excess of (i) a taxpayer's aggregate trade or business deductions for a taxable year *over* (ii) that taxpayer's aggregate trade or business gross income or gain for the taxable year plus a threshold amount.
    - The threshold amount is equal to $250,000, or $500,000 for taxpayers filing a joint return.
    - Disallowed excess business losses are treated as a net operating loss carryover to the following tax year.

NOLS, TECH TERMS, EXCESS BUSINESS LOSSES, LKE

- Technical Terminations (Section 708(a)(1)(B))
  - – Tech Term rules repealed
- Like-Kind Exchanges
  - – Limited to real property

THANK YOU

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