DrillingDOWN

Issues Impacting the Oil & Gas Industry

Drilling Down: A deeper look into corporate integration

As discussions on Capitol Hill regarding tax reform continue, Senate Finance Committee Chairman Orrin Hatch (R-UT) appears poised to weigh in with the expected release of a significant corporate tax reform proposal. Although the exact timing remains unclear, Chairman Hatch has indicated that within the coming months he intends to unveil a draft "corporate integration" legislation to alleviate the double taxation of corporate earnings. In this edition of KPMG Global Energy Institute's *DrillingDOWN*, we ask John Gimigliano and Jennifer Gray to discuss what we might expect and what the implications could be for the industry.

1. What issues is the corporate integration proposal expected to address?

The draft proposal is expected to focus upon identifying and correcting many of the perceived distortions caused by the current system of the double taxation of corporate income. Namely, the U.S. currently taxes the same income at the corporate level with a corporate income tax and again at the shareholder level with a tax on dividends received.

In particular, the proposal is likely to focus upon eradicating or diminishing the following four distortions that have been identified by the committee as flowing from by the current system of double taxation:

- The bias in favor of pass-through entities versus corporations as a form of business organization
- The bias encouraging debt financing over equity financing
- The bias encouraging corporations to retain earnings rather than to pay dividends to shareholders
- The bias in favor of particular methods of the distribution of corporate earnings over other methods

2. Why release the draft proposal now?

Senator Hatch is anticipating that this proposal could be a potentially significant component of tax reform. Although the consensus is that significant tax reform will not be accomplished in this election year, there is a growing sense that increased pressures on the U.S. tax system will create incentives to enact significant tax reform in coming years.

With the potential release of a detailed proposal, Senator Hatch will be laying down a marker illustrating his preferred approach to combatting the pressures imposed on the U.S. tax system by tax competition, high-profile corporate inversions and BEPS-related changes, among other factors.

Welcome to the sixth edition of *DrillingDown*, the KPMG Global Energy Institute's monitor of key issues for decision makers in the global oil and gas sector. *DrillingDOWN* offers insights from KPMG thought leaders on the trends that are driving and shaping oil and gas companies today.

John Gimigliano
Principal in Charge,
Federal Legislative and Regulatory Services practice
KPMG LLP (U.S.)

Jennifer Gray
Director,
Washington National Tax
KPMG LLP (U.S.)

About the GEI

The KPMG Global Energy Institute (GEI) is a worldwide knowledge-sharing forum on current and emerging industry issues. Launched in 2007, the GEI interacts with its over 30,000 members through multiple media channels, including audio and video Webcasts, publications and white papers, podcasts, events, and quarterly newsletters. To become a member, visit www.KpmgGlobalEnergyInstitute.com

3. Why is corporate integration being considered as a possible topic for tax reform?

A corporate integration approach has the potential to address a number of the thornier issues that policymakers have been wrestling with as they examine options for tax reform. By relieving the impact of double taxation, corporate integration will likely make the C-corporation form of business entity more attractive to business owners and investors as well as lessen the importance of the differential between the U.S. corporate tax rate and that of other countries. A high-profile potential impact of a corporate integration plan could be to lessen the pressures upon U.S. companies to consider engaging in "inversion" deals as a means to lessen the tax burden upon a U.S.-based corporation. Likewise, the elimination of a layer of tax on corporate earnings could also lessen pressures upon U.S. companies to permanently invest foreign-earned profits abroad and encourage corporations to return those profits to the United States as dividend payments to shareholders.

4. What is the draft corporate integration proposal expected to look like?

There are a number of ways to attack the issue of the double taxation of corporate income and it is expected that the forthcoming draft authored by Chairman Hatch and his staff will focus upon a dividends paid deduction (DPD) combined with a withholding tax on dividends.

A DPD will generally result in one layer of tax being imposed on distributed corporate earnings and will generally move that tax to the shareholder level. Under a DPD regime, a corporation receives a deduction from a corporate-level tax for dividends paid to shareholders much as the corporation currently receives a deduction for interest payments on debt.

The shareholders would then include the dividends received from the corporation as individual income, much as they do under current law. One of the critical issues for the draft proposal is the rate at which tax will be imposed upon the dividend income at the shareholder level. The dividend income could be subjected to ordinary income tax rates (currently as high as 39.6%) or could be taxed at a separately determined tax rate, which could be higher or lower that the current odinary rate.

This DPD regime would generally result in one layer of tax being imposed upon distributed corporate earnings. Note, however, that retained earnings would continue to be subject to a corporate-level tax.

To address the concern that dividends paid to tax-exempt or foreign shareholders might entirely escape any tax, it is expected that the draft to be released by Senator Hatch will include a withholding tax—likely at the highest applicable corporate tax rate—on all dividends paid to shareholders. Taxpayers would then receive a nonrefundable credit equal to this withholding tax against their income taxes when the dividends are included in their income. Note that, as it is a nonrefundable credit, dividends subject to a tax rate lower than the top corporate rate will not benefit wholly from the full credit for the withholding taxes. In the case of a tax-exempt or foreign shareholder, the withholding tax could serve as a final tax on the dividends.

5. Why is a withholding tax being considered?

A primary issue that creates a challenge for policymakers when developing a corporate integration proposal is the question of how to ensure that corporate profits would be subjected to at least one—but only one—layer of taxation. When developing a proposal that would shift the tax burden to the shareholder rather than the corporate level, this task can be particularly difficult with regard to shareholders that are not subject to U.S. tax such as foreign shareholders and tax exempt shareholders (such as pension plans). As described above, the proposal expected to be unveiled by Senator Hatch is likely to include a withholding tax component to ensure the collection of the tax. However, while addressing some of the challenges proposed by nontaxpaying shareholders, a withholding tax could create other challenges.

If a withholding tax is imposed upon dividend payments, then dividend payments could still be less attractive to investors than interest payments unless a similar withholding tax were also imposed upon interest payments made by corporations.

An additional challenge will be to determine how such a withholding tax regime would interact with the current U.S. tax treaties—many of which provide for relief from current withholding taxes imposed on dividends received from U.S. corporations by foreign shareholders.

6. What is the timing and expectations of progress for the draft proposal?

Although the exact timing of the release of the proposal is unclear, recent public statements by Chairman Hatch indicate a time frame to release the proposal in 2016. The Senate Finance Committee staff continues to finalize a number of technical issues in the draft as well as reportedly work with the Joint Committee on Taxation to analyze its potential impact on federal revenue.

With the expectation that tax reform is an event that will not take place until well after the inauguration of a new administration in January 2017, a release of the draft proposal in 2016 will provide time for a free flow of information and ideas between Congressional tax writers and the business and tax professional community, as well as the general public. Based on similar previous exercises, it is likely that future versions of the proposal would reflect this feedback.

7. How will the legislation impact the oil and gas industry?

Many questions remain with regard to how a corporate integration proposal would impact the oil and gas industry, but it is clear that the implications have the potential to be wide-ranging for all segments of the industry.

As a highly capital intensive and often highly leveraged industry, significant analysis will be needed to determine how this proposal would change the corporate dynamics influencing decisions regarding the financing of investment and ongoing operational needs, as well as the factors impacting retained earnings vs. dividend distribution decisions.

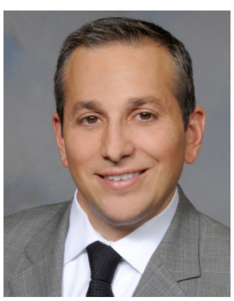
The potential impact upon the investing and operating environment caused by the need for modifications to existing and new tax treaties created by the proposal's significant changes to domestic laws will need to be analyzed by the industry. It is clear that the shifting of the tax burden and the imposition of a dividend withholding tax as contemplated by the proposal will modify the return analysis of U.S. corporate investments for non-U.S. investors.

With large segments of the oil and gas industry engaging in significant operations in high-tax foreign jurisdictions, the implications of the many remaining open questions regarding the interaction of the foreign tax credit regime with the proposed DPD system have the potential to be particularly impactful for this industry.

An additional open question with the implications for some segments of the industry is how the impact of the new proposal upon taxpayers who pay the alternative minimum tax (AMT taxpayers) might be different than upon non-AMT taxpayers.

In addition to the substantial impact such significant changes in the corporate tax regime would have upon the industry's corporations, the impact of the new regime upon the industry's MLP sector is uncertain. It is possible that a corporate integration proposal may provide that all publicly traded businesses—regardless of entity form—would be subject to the new rules (i.e., treated as C corporations for tax purposes). If this were to be the case, then the potential for disruption in some sectors of the oil and gas industry would be profound.

Contact us:



John Gimigliano
Principal in Charge, Federal Legislative and Regulatory Services practice
KPMG LLP (U.S.)

Jennifer Gray
Director, Washington National Tax
KPMG LLP (U.S.)

www.KpmgGlobalEnergyInstitute.com

kpmg.com/socialmedia