Drilling Down: Tax implications of COVID-19 and low commodity prices

Strategies to help manage liquidity and debt concerns

In this edition of KPMG Global Energy Institute's *Drilling Down*, we asked Michael Terracina and Robert Swiech about tax-related issues oil and gas companies should keep top of mind in the current environment.

Clearly, the oil and gas sector is struggling with the combination of weak commodity prices due in large part to the recent battle between Saudi Arabia and Russia and depressed fuel demand from measures to stop the spread of COVID-19.

As companies look to mitigate the negative impacts of this dual challenge, they can consider several tax developments and factors that may be of greater importance to the oil and gas sector in this difficult environment.

Many oil and gas companies are dealing with unstable cash flows in these difficult economic conditions. Which provisions in the CARES Act could help taxpayers?

There are numerous provisions beneficial to the oil and gas industry in the Coronavirus Aid, Relief and Economic Security Tax (CARES Act) and other administrative guidance, but one provision that may provide much-needed relief is the changes made to the net operating loss (NOL) carryback rules.

First, the CARES Act expanded the rules allowing taxpayers to offset pre-2018 ordinary income or capital gains that were taxed at higher rates, thereby generating a current refund and a favorable rate differential.

Under the Tax Cuts and Jobs Act (TCJA), post-2017 NOLs could not be carried back, and pre-2018 NOLs could be carried back only two years. The CARES Act now allows taxpayers to carryback NOLs in tax years beginning after 2017 and before 2021 for five years. The NOL is carried back to the first eligible tax year (i.e., five years) and then claimed against federal taxable income in years four, three, two, and one. Taxpayers have an opportunity to offset ordinary income or capital gains for this period that were taxed at up to 35 percent. The IRS is expected to issue guidance on which IRS form should be filed to claim the refund.

Additionally, taxpayers may obtain permanent cash tax savings by filing accounting method changes for either 2019 or 2020 to accelerate deductions or defer revenue and increase the NOLs in those years. While specifically not a CARES Act provision, in determining the NOL carrybacks, consideration must be given to section 382(h)(4), which requires confirmation that an ownership change did not occur in the NOL year (or the preceding five years) and, if an ownership change did occur, there is not a net unrealized built-in loss (NUBIL) at the time of change.

The bill temporarily suspends the 80 percent of taxable income limitation on the use of NOLs for tax years beginning before January 1, 2021, thereby permitting corporate taxpayers to use NOLs to fully offset taxable income in these years—regardless of the year in which the NOL arose.

It should also be noted that the CARES Act incorporated a technical correction to the TCJA to provide that the 80 percent taxable income limitation is determined after giving effect to the use of pre-2018 NOLs. Also, the CARES Act provides that taxable income is determined without giving effect to the deductions for qualified business income, foreign-derived intangible income (FDII), and global intangible low-taxed income (GILTI), under sections 199A and 250, respectively.

Another CARES Act provision potentially impacting oil and gas companies temporarily increases the interest expense deduction limitation under 163(j) from 30 percent to 50 percent of adjusted taxable income (ATI) for tax years beginning 2019 and 2020. The 50 percent-instead-of-30 percent ATI rule does not apply to a partnership tax year beginning in 2019, but (unless a partner otherwise elects out) for any of the partnership's 2019 excess business interest expense that is allocated to a partner. The changes to 163(j) potentially increase a company's NOLs, which is a further benefit when combined with the changes to the NOL provisions.

Are there other important considerations that may help oil and gas companies with near-term cash flow needs?

While the NOL and interest expense limitation changes discussed above are some of the most significant to the oil and gas industry, there are numerous other recent developments that could benefit oil and gas companies as well. As these provisions are covered more in-depth in other KPMG publications, we will only briefly mention some of the more relevant provisions in the CARES Act and IRS Notice 2020–18:

— Delay in certain tax filings and payments from April 15 to July 15, 2020

— Acceleration of alternative minimum tax credits (MTCs)

— Delay in employer and self-employment payroll taxes

— Employee retention payroll tax credit.

April 28, 2020

In addition to the tax provisions included, the CARES Act also provides relief through various loan programs including the Paycheck Protection Program (PPP), Economic Injury Disaster Loans (EIDL) and loan advances, and SBA Express Bridge Loans (EBL).

As oil and gas companies are looking for sources of liquidity, it is important to consider nonfederal income tax areas including state and local sales and use taxes, severance and production taxes, foreign value-added taxes, and property taxes, to name a few. Many states are adopting their own rules around filing and payment relief and other incentives.

A number of companies may be looking to modify the terms of their outstanding debt instruments. What potential tax impact should borrowers prepare for?

A reduction of the amount of principal in a debt instrument, whether recourse or nonrecourse, may be considered a cancellation of indebtedness income (CODI), which can generate ordinary income.

Alterations of debt to reduce principal or interest rates can cause a taxpayer to incur CODI, even where the principal amount of the debt is unchanged. However, the usage issue for NOLs arising in the 2018, 2019, and 2020 taxable years may mitigate the interest deductibility issue. Borrowers will need to run tax models to determine the extent of any net tax cost to such a modification.

Borrowers could potentially exclude CODI from income in certain circumstances, such as insolvency or bankruptcy. Keep in mind that many upstream and midstream assets are operated in pass-through form for tax purposes. The owners of the entities rather than the entities themselves are responsible for the tax burden associated with a debt modification. CODI exclusions apply at the owner level for pass-through borrowers.

Finally, oil producers raising capital through sales of a volumetric production payment (VPP) to real estate investment trusts (REITs) can treat a VPP as a real estate mortgage, since it is an eligible asset or collateral for the REIT. This is important for the issuer because a VPP may protect the underlying cash flows in a bankruptcy where the sale of a VPP provides sufficient liquidity to prevent the need for a debt modification or workout.

How can oil and gas companies plan to optimize their company's tax positions as they prepare for oil prices to rebound and the immediate challenges around COVID-19 to pass?

While the hope is that the economic recovery and resulting increase in commodity prices will follow shortly thereafter, well-advised companies should consider tax planning and tax positions based on the reality of the current situation. It is expected that many companies will record impairments for financial reporting purposes in the upcoming quarterly filings.

Also, depending on the extent to which companies have hedged their production, they may be reporting significantly lower financial performance than prior quarters. There are significant differences in the timing of reporting income and deductions for financial and tax purposes, but companies should ensure that they are availing themselves to appropriate tax planning that reflects the economic realities that low commodity prices have on their assets.

The energy industry has proven its resilience time and again. We are inspired by our efforts to work together to help ensure the industry makes a strong recovery from the current challenges and continues to expand and secure energy access for people all around the world.

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. Subscribe today to begin receiving valuable insights covering critical business topics and industry issues by visiting read.kpmg.us/gei.

Robert Swiech
Director, Washington National Tax
KPMG LLP
E: rswiech@kpmg.com

Mike Terracina
National Tax Leader, Oil and Gas
KPMG LLP
E: mterracina@kpmg.com

Some or all of the services described herein may not be permissible for KPMG audit clients and their affiliates or related entities.

kpmg.com/socialmedia

April 28, 2020