Tax Benefits of the CARES Act to Energy Companies

Executive Summary

Issue:

As the end of 2020 draws near, the benefits to energy companies of The Coronavirus Aid, Relief, and Economic Security (CARES) Act should be kept in mind for 2020 tax filings. The CARES Act was signed into law on March 27, 2020, and includes broad measures to provide assistance, economic stimulus, and relief to American companies and individuals. Certain measures included in the act are of significance to energy companies, particularly oil and gas upstream exploration and production companies which have faced difficulties in 2020 due to the drop in demand and commodity prices created by the COVID-19 pandemic. Other energy companies such as renewable energy-focused companies may also find benefits as well.

Solution: Key measures in the CARES Act which should be considered include the reinstatement of net operating loss (NOL) carrybacks, more lenient guidelines for the business interest deduction, and the treatment of intangible drilling costs. Valuation and analytical work in this industry needs to be done by firms that have the requisite experience and technical ability, as well as a strong understanding of the industry specifics and value drivers. Generalists will make mistakes you cannot afford.

TEXT

On March 27, 2020, President Trump signed into law the Coronavirus Aid, Relief, and Economic Security (CARES) Act which included a broad number of measures aimed and providing relief and economic stimulus to the United States economy in response the onset of a global pandemic caused by the COVID 19 virus. Many oil and gas exploration and production companies had already been facing difficulties before the pandemic due to a price war between Saudi Arabia and Russia, leading to lower commodity prices. Certain measures of the CARES act could provide some real short-term benefit and liquidity to oil and gas companies as well as to other companies across the broader energy space. Below is a summary of some of the CARES Act provisions which could be of use to energy companies.

NOL Carrybacks

One of the most significant changes to tax law from the CARES Act is the reinstatement of the net operating loss (NOL) carryback provisions under IRC section 172 and the lifting of the 80% limitation on NOLs for future periods. The ability to apply NOLs to prior periods was removed with the passing of the Tax Cuts and Jobs Act (TCJA) in 2017, and it also limited application for future periods to only 80% of the operating loss. The new CARES act allows companies to carry back NOLs incurred in tax years 2018-2020 for up to five years, offsetting 100% of taxable income in those periods. Of particular advantage for oil and gas companies is the ability to apply NOLs incurred during periods of low commodity prices to those of higher commodity price environments, including periods where the prior 35% tax rate was applicable.

Sources of NOLs could be current year operating losses given lower commodity prices, as well as asset impairments for long-lived assets such as plant and equipment and oil and gas reserves, particularly those with shorter expected lives. An oil and gas company with marginally profitable reserves in recent periods could support impairing those assets in the current environment, thus creating or increasing an NOL for the current year. Additionally, oil and gas companies could review oil and gas leases, and impair the value and costs associated with any abandoned or expired leases. Lastly, the TCJA also increased the bonus depreciation percentage to 100% for qualified property acquired and placed between September 27, 2017 and January 1, 2023. As such, it might be possible and advantageous for oil and gas companies to utilize bonus depreciation in the current tax year in order to create NOLs to carry back, however the decision should also consider Management's business outlook and as a consequence its assessment of the value of such depreciation in future years. Receiving cash in the form of significant refund checks made possible by NOL carrybacks would be welcomed by a company seeking additional liquidity currently amid lower demand and commodity prices stemming from the COVID pandemic.

For renewable energy companies, accelerated Modified Accelerated Cost Recovery System (MACRS) depreciation could have additional value as facilities which came online in 2018 or 2019 could elect to apply NOLs stemming from the significant depreciation deductions associated within the first two years of the 5-year MACRS schedule to earlier periods when the 35% tax rate was in place. As mentioned above for oil and gas companies, renewable companies may also find value in utilizing bonus depreciation aside from accelerated depreciation for the purposes of utilizing NOLs. For certain tax equity structures, these depreciation elections could increase the internal rate of return of the tax equity investment, resulting in earlier flip periods and higher overall cash investment returns than originally expected.

Business Interest Deduction Changes and Intangible Drilling Costs

In addition to operating losses stemming from lower commodity prices, oil and gas companies can also take advantage of changes in the deductibility of business interest costs. Another provision of the CARES Act was the change in the limitation of interest deductibility from 30% of adjusted taxable income to now 50%, however the change is only applicable to the 2020 tax year. As a result, certain energy companies with significant leverage may be able to better utilize interest costs as deductions and operating losses this tax year.

Oil and gas companies can also potentially create or increase operating losses by deducting intangible drilling costs (often in the form of wages, fuel, and supplies) which may be deducted or capitalized for tax purposes. If deducting the intangible drilling costs would not result in an operating loss that could be carried back and utilized to create refunds, companies should consider capitalizing the costs and deducting over a 5-year period, creating positive value as a deduction in a hopefully higher earnings environment.

ValueScope Can Assist You

Overall, the CARES Act includes several benefits to energy companies. ValueScope can assist your company in its tax and financial reporting requirements, especially when valuation and cash flow forecasting are at play, such as in the asset impairment process. ValueScope's energy team provides services to clients operating across the entire energy industry, from oil and gas producers to renewable energy generators. Our expertise is deep and broad, which allows us to offer specific technical and industry insights and capabilities that cannot be matched by generalist firms. We have a rare combination of industry, banking, consulting, valuation, and government experience at ValueScope. We understand all of the factors and drivers that move energy markets today.