Tax Provisions in Biden Administration's FY 2022 Budget Proposals

Asset management

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Introduction

KPMG LLP on May 31, 2021, released a 117-page **report** [PDF 1.4 MB] containing analysis and observations of tax proposals in the Biden Administration's FY 2022 budget. For ease of reference, KPMG has compiled summaries and observations relating to certain industries and topics in separate booklets. This booklet highlights revenue proposals relevant to the asset management industry. Other booklets address proposals relating to other topics. This booklet reflects developments and analysis as of June 28, 2021. For information regarding subsequent developments, read ***TaxNewsFlash-Legislative Updates***.

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This report is organized as follows:

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Background

The Department of the Treasury ("Treasury") on May 28, 2021 released its "**General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals**" [PDF 884 KB]. This document, better known as the "Green Book," outlines the Biden Administration's tax proposals in greater detail than seen before, including information on proposed effective dates, Treasury revenue estimates, and design choices.

During the presidential race of 2020, President Joe Biden actively campaigned on an ambitious tax plan. His campaign tax plan was in some ways centered on the idea that the major tax legislation enacted in 2017 typically called the Tax Cuts and Jobs Act ("TCJA"), championed by the Trump Administration, had cut taxes too much and in the wrong ways. Read **KPMG's detailed analysis of the TCJA** [PDF 6.4 MB]

As such, candidate Biden's tax plan was built around raising the corporate tax rate, raising taxes on the foreign earnings of U.S. multinationals, and raising taxes on wealthy individuals (including increases in the ordinary and capital gains tax rates). The plan would then redirect that tax revenue to other priorities, such as infrastructure spending and support for middle and low-income earners.

Since becoming president, Biden has continued to champion mostly the same ideas from his campaign. He has, however, focused his legislative efforts so far on a narrower set of tax proposals than in his campaign, while introducing several new proposals.

The FY 2022 Green Book represents the Biden Administration's current tax priorities—signaling to Congress the administration's view that these ideas are of greatest importance to his current legislative agenda. With Congress gearing up to consider major tax and infrastructure legislation later this year, the Green Book ideas are likely to be central to those discussions. Biden Administration officials were, no doubt, keenly aware of this fact when developing these proposals.

While the Green Book includes a great deal of information, it nevertheless leaves many questions unanswered. Those answers may be delayed pending actual legislative text from Congress, or, if legislation based on the proposals is enacted, post-enactment regulatory guidance from Treasury. But, for now, the Green Book reflects the most detailed exposition of the administration's current legislative priorities for the U.S. tax system.

With that in mind, what follows in this document is KPMG's detailed explanation of the Biden Administration's tax proposals and potential impact on the asset management industry. This analysis includes observations on what the Biden proposals might mean for fund participants and portfolio company investments, observations on what the proposals include, and often observations on what they do not.

KPMG observation

The Biden Administration has set out an ambitious, long-term infrastructure and social support program. Congress might act on all or part of that program, or indeed, could add to it. The revenue-raising tax proposals set out in the budget are designed to offset the cost, over time, of the proposed increases in spending and tax incentives. Some might face challenges in the legislative process and could be modified or eliminated during congressional consideration of potential legislation.

Additional proposals could be added, as well. Several proposals put forth by then-candidate Biden during the presidential campaign that could have a significant impact on investment funds and participants have not been included in the budget proposals —such as further changes to the taxation of estates (beyond the changes described in the Green Book); repeal of the section 199A deduction for pass-through businesses; a 28% cap on the tax benefit of itemized deductions; a tax on the assets of financial institutions; and a modification of the income cap for payroll taxes.

Numerous other revenue-raising (and other) proposals have been put forth by members of Congress.

It would not be surprising if there were significant modifications made to the Biden Administration's tax proposals if and when they are considered in Congress.

Considerations for sponsors and individual investors

Taxation of capital income

Tax capital income for high-income earners at ordinary rates

Under current law, long-term capital gains and qualified dividends are subject to income tax at a rate of 0%, 15%, or 20%, with the applicable tax rate based on a taxpayer's taxable income and filing status. In addition, single taxpayers with modified adjusted gross income in excess of $200,000 ($250,000 for married taxpayers filing jointly) are assessed an additional 3.8% net investment income tax (NIIT) on their long-term capital gains and qualified dividends, which effectively results in a current maximum tax rate of 23.8%.

Proposal

The administration's proposal would increase the tax rate on long-term capital gains and qualified dividends for high-income taxpayers by taxing such income at ordinary income tax rates (currently 37% for high-income taxpayers) for taxpayers with AGI in excess of $1,000,000, but only to the extent that the taxpayer's income exceeds $1,000,000 ($500,000 for married filing separate taxpayers), with amounts indexed for inflation after 2022.

The Green Book provides examples of how this proposal would work in practice:

> A single taxpayer with $900,000 in labor income and $200,000 in long-term capital gain income would have $100,000 of the capital gain taxed at the current preferential tax rate (23.8% including the NIIT), while the remaining $100,000 of gain, the amount in excess of $1,000,000, would be subject to tax at ordinary income tax rates.
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> Conversely, a single taxpayer with $1,100,000 in labor income and $500,000 in long-term capital gain income would have all long-term capital gain income taxed at ordinary income tax rates under the administration's proposal.

As described in the Green Book, the proposal would be effective for gains required to be recognized after the date of announcement.

KPMG observation

As mentioned, the proposal would be effective for gains required to be recognized after the "date of announcement," which date is not specified in the Green Book. It is possible that this date refers to April 28, 2021, which is the day on which President Biden made a speech to Congress and released a fact sheet describing the "American Families Plan."

While Congress would make a final determination regarding effective dates of any proposals which may be enacted, it is interesting to note the potential consequence of a "date of announcement" effective date.

For instance, a taxpayer with AGI in excess of $1,000,000 may be subject to two different tax rates during 2021: the taxpayer would be subject to a top tax rate of 20% (23.8% including the NIIT) on long-term capital gain and qualified dividend income recognized on or before the date of announcement, and 37% (40.8% including the NIIT) on such income recognized after the date of announcement.

Additionally, if the administration's separate proposal that would increase the top ordinary individual income tax rate to 39.6% for tax years beginning after December 31, 2021 were enacted, that same taxpayer would be subject to a top tax rate of 39.6% (43.4% including the NIIT) on long-term capital gain and qualified dividend income recognized during the 2022 tax year.

It appears the proposed retroactive effective date could serve to slow taxpayers from selling assets with the goal of recognizing gains prior to a rate increase. The delay in the ordinary income rate increase to 2022, however, does provide a window of opportunity for taxpayers to accelerate sales into 2021 to achieve at least 2.6% in tax savings.

KPMG observation

Even though the proposed top Federal capital gains tax rate of 43.4% (assuming the administration's separate proposal increasing the top ordinary income tax rate is enacted and taking into account the NIIT) would be substantially lower than the top tax rates that applied to capital gains during the 1910s and 1920s, it would be the highest in modern times, as well as the highest of any of the 38 OECD member countries.

KPMG observation

Setting the effective date as the date of announcement likely had the effect of limiting some tax planning. Given the uncertainty of the ultimate effective date in the event the proposal is enacted, taxpayers should still consider whether sales of capital assets or distributions of qualified dividends are best taken into account in 2021.

KPMG observation

If enacted, the proposed increase in the top Federal capital gains tax rate would increase the impact of tax incentives that exclude gains from taxable income. For example, section 1202 provides that gross income does not include 50 percent of any gain from the sale or exchange of qualified small business stock held for more than 5 years. With an increased capital gains tax rate, the after-tax returns of qualified small business stock may be enhanced relative to other investments.

KPMG observation

Investment fund sponsors should evaluate tax distribution provisions both at the fund level and for portfolio companies to ensure required tax distributions would be sufficient to cover cash taxes if the top Federal capital gains tax rate is increased or other changes are enacted.

KPMG observation

Depending on how the rate change is implemented if enacted, the proposal may impact the withholding tax rates applicable under section 1446(a) on foreign taxpayers with respect to capital gains that are effectively connected with the conduct of a U.S. trade or business. Given the possibility that the income may ultimately be taxed at a higher rate than the applicable withholding, foreign taxpayers should assess their estimated income tax payments in light of potential rate increases.

KPMG observation

Most states do not differentiate between the tax rate applied to capital gains income and ordinary income, meaning that the administration's proposed change would not have a direct impact at the state level. Even for states that apply a different capital gains tax rate to this income, the tax rate used by the state is not tied to the federal tax rates.

Treat transfers of appreciated property by gift or on death as realization events

Under current law, neither a transfer at death nor a gift during life is a realization event subject to federal income tax (although such transfers may be subject to federal gift, estate and/or generation-skipping transfer tax). Section 1014 provides that the basis of property acquired from a decedent generally is the fair market value of the property on the decedent's date of death (often referred to as a "stepped-up basis"). Section 1015 provides that the basis of property received by gift is generally the same as that of the donor (often referred to as a "carry-over basis").

The administration's FY 2022 proposal would treat a transfer (as defined under the gift and estate tax rules) of an appreciated asset, either at death or by gift during life, as an income tax realization event (subject to special rules and exceptions described later). Gain, equal to the excess of the fair market value of the asset over the donor's basis on the date of death or gift, would be taxable income to the decedent or the donor and would be reported on the estate or gift tax return or on a separate capital gain return. Capital losses and carry-forwards from transfers at death would be allowed to offset capital gains recognized at death and up to $3,000 of ordinary income on the decedent's final income tax return. Taxes on gains deemed realized at death would be deductible on the decedent's estate tax return.

KPMG observation

Senator Van Hollen has offered a **discussion draft** of legislation and Congressman Pascrell has introduced a **bill** that would treat gifts and bequests as realization events in a somewhat similar manner to the administration's proposal. It is unclear how closely any legislation that might be based on the administration's proposal would resemble these congressional proposals.

KPMG observation

The title of the proposal in the Green Book—"Treat transfers of appreciated property by gift or on death as realization events"—indicates that transfers by gift or on death would be realization events which could suggest that such transfers would be treated as deemed sales with the transferor recognizing gain or loss depending on the relationship between the transferred asset's fair market value and basis. However, the body of the proposal primarily focuses on gain so it is not entirely clear whether a loss could be realized as a result of a gift or bequest. As mentioned above, there is one comment about using capital losses and carry-forwards "from transfers at death" to offset capital gains "recognized at death." Perhaps this suggests realization of losses in addition to gains under the proposed rule; however, carry-forwards would not be caused by transfers at death, so this language is somewhat confusing. To add to the confusion, only use of losses at death is described but logic would seem to suggest that losses and carry-forwards should be available to offset gain from lifetime transfers as well.

KPMG observation

In addition, in order to utilize any losses as offsets and calculate income tax liability, presumably the gain from these deemed realization events would need to eventually end up on the individual income tax return (even if also required to be reported on the estate or gift tax return).

KPMG observation

The ability to deduct the capital gains tax on the estate tax return of the decedent may help to mitigate the impact of the application of both the estate and income tax to the same transfer. The proposal does not seem to contemplate a corresponding provision for taxes on gains deemed realized at the time of a gift.

KPMG example

Taxpayer has previously fully utilized his gift and estate tax lifetime exemption amount. At Taxpayer's death in 2022, he owns stock worth $10 million with zero basis. If the deemed realization proposal is enacted (as well as the proposal to increase capital gain rates to match ordinary income rates), Taxpayer would be subject to tax on the $10 million of gain (assuming exclusions do not apply) at 43.4% (including 3.8% net investment income tax) and his estate would pay $4.34 million in income tax. After taking the proposed deduction for such income tax in calculating the estate tax, the Taxpayer would be left with a taxable estate of $5.66 million which would be taxed at 40%, resulting in estate tax liability of $2.264 million. The Taxpayer's effective tax rate would be 66.04%, leaving $3.396 million for his heirs.

Assume instead that, in 2022, Taxpayer decided to gift the shares to his heirs prior to death and has previously fully utilized his gift and estate tax lifetime exemption amount. Taxpayer would again have $10 million of gain (assuming exclusions do not apply) taxed at 43.4% and the Taxpayer would owe $4.34 million in income tax. The administration's proposal does not appear to provide any deduction for that income tax in calculating the Taxpayer's gift tax liability. As a result, the Taxpayer would also owe $4 million in gift tax ($10 million taxed at 40%). Taxpayer's effective tax rate for the gift would appear to be 83.4%.

The proposal would also require unrealized gain in assets owned by a trust, partnership, or other non-corporate entity to be recognized if the property had not been the subject of a recognition event within the prior 90 years, and such testing would be for periods beginning January 1, 1940. Accordingly, a recognition event would not occur under this provision until December 31, 2030.

KPMG observation

For any entity that is not a corporation, this provision would appear to require recognition of an asset's unrealized gain that has not been the subject of a recognition event in the prior 90 years whether or not the impacted entity has itself held the property for 90 years. This would raise potential due diligence concerns in connection with tax-deferred acquisitions, including in the context of a non-taxable contribution or distribution from a non-corporate entity such as a partnership. This provision could be relevant for private equity funds acquiring portfolio companies in a manner that allows for non-taxable continued ownership (i.e., rollover) by the historic owners. It is not clear if an S corporation would be treated as an excepted "corporate entity" for this purpose or whether an entity disregarded as separate from an individual, such as a wholly owned limited liability company, would be treated as an entity for this purpose. It is also not clear if a distribution of property held by a partnership to an individual taxpayer prior to the end of the 90-year period would avoid the automatic gain recognition. In addition, it is not clear whether this provision would take into account recognition events with respect to the interests in the partnership that may have been sold or exchanged at a time the relevant assets were held by the entity.

KPMG observation

The proposal appears to impose a type of mark-to-market regime on not only long-term dynasty trusts but also partnerships and other non-corporate entities. It is unclear whether this was intended or whether the proposal might ultimately be narrowed to focus on trusts and other family-controlled entities.

Under the proposal, a transfer would be defined and valued using the gift and estate tax provisions. However, in determining the capital gains tax due, a transferred partial interest in property would be valued as a "proportional share of the fair market value of the entire property."

KPMG observation

For purposes of calculating the capital gains realized on a transfer of a partial interest in property, the proposal could be interpreted as an attempt to limit or eliminate valuation discounts, including those for lack of marketability or lack of control.

Transfers of property into, and distributions in kind from, a trust (other than a revocable grantor trust), partnership, or other non-corporate entity would also be treated as recognition events. The grantor of a revocable grantor trust would recognize gain when (1) appreciated assets are distributed from the trust to anyone other than the grantor or grantor's spouse, (2) the grantor dies, or (3) the trust otherwise becomes irrevocable.

KPMG observation

The proposal's specific inclusion of transfers of property to and from a partnership or other non-corporate entity is surprising. Although not clear, it seems unlikely that this is intended to override the general non-recognition rules under sections 721 and 731 upon a contribution of property to, or distribution of property from, a partnership. Rather, the provision might have been intended to apply in a narrower context where the contribution or distribution would result in a gift under the gift tax provisions.

KPMG observation

Although the proposal indicates that whether a certain transfer is taxable will turn on gift and estate tax constructs, it is far from clear what that really means. Will a transfer only result in a realization event if it is also a completed gift for gift tax purposes? Or is transfer defined more broadly to mean a transfer for property law purposes (even if such transfer is not complete for gift tax purposes)? Or, since this is an income tax proposal, is the focus more on whether there is a transfer for income tax purposes? It is even more difficult to determine what "distributions" will constitute realization events as distributions do not usually have gift or estate tax implications. Distributions do have relevance in determining the income taxation of a non-grantor trust and its beneficiaries so perhaps the proposal will apply to anything that constitutes a distribution for trust income tax purposes. But what about a distribution from a grantor trust where these income tax rules are not applicable? Or a distribution back to the grantor where the initial transfer was not a completed gift? Or could the intent be to cover any retitling of trust assets in someone else's name for property law purposes (even, perhaps, in the context of a sale for full and adequate consideration)? Unfortunately, the reach of the proposal is impossible to discern until the meaning of these terms—transfer and distribution—is clarified.

KPMG observation

As discussed, it is not clear what specific transfers to or distributions from trusts will be treated as deemed realization events under the proposal; this makes it difficult to assess the impact of the proposal on various trusts set up for estate planning purposes, such as a grantor retained annuity trust (GRAT) or a sale to an intentionally defective grantor trust (IDGT). Would the proposal apply to the initial transfer to the trust? For an IDGT, the answer appears to be yes because it is a completed gift for gift tax purposes. But only the remainder interest in a GRAT is a completed gift and that amount is typically worth close to zero when a short-term, high payout GRAT is utilized, so it is unclear whether creation of such a GRAT would be a deemed realization event. Would the proposal apply to a distribution of appreciated assets by a GRAT to the grantor in satisfaction of the grantor's annuity payment? The grantor is already the owner of the GRAT assets for income and transfer tax purposes, but perhaps this could still be a realization event if distribution means a change in title for property law purposes. It is also not clear whether a sale of appreciated assets from the grantor to an IDGT (which are generally treated as disregarded for federal income tax purposes) in exchange for a promissory note or the trust's use of appreciated assets to satisfy its obligations under the promissory note would be a "transfer of property into" or a "distribution in kind from" the trust and therefore a realization event. Treatment of the exercise of a substitution power is similarly uncertain—is reacquiring appreciated assets from a trust in exchange for other assets of equivalent value one or both of a "distribution from" or a "transfer to"? If the proposal is developed further to treat many of these aspects of GRATs and sales to IDGTs as realization events, the tax benefits associated with these popular estate planning techniques could be significantly reduced. It is worth noting, however, that many of the proposals made by prior administrations that might have had a negative impact on GRATs (e.g., minimum gift amounts or longer required terms) and sales to IDGTs (e.g., inclusion of sold assets in the grantor's estate) are not included in this proposal.

Transfers to certain persons or transfers of certain property would not result in the deemed realization of gain. For example, no gain would be realized on a transfer at death to a U.S. spouse; the surviving spouse would own the property with a carry-over basis and gain would only be recognized when the spouse subsequently disposed of the assets or died. In addition, no gain would be generated on the transfer of appreciated property to charity. However, in the case of a transfer of appreciated assets to a charitable split-interest trust (e.g., charitable remainder trusts and charitable lead trusts), only the charity's share of the gain would be excluded.

KPMG observation

No similar exclusion for gifts to a U.S. spouse is mentioned. It is unclear if this was an oversight or a policy decision but given the proposal's broader language regarding charitable transfers—which appear to be excluded whether they occur during life or at death—perhaps the same treatment was intended for marital transfers as well.

KPMG observation

Also uncertain is the definition of U.S. spouse in connection with this proposal; however, it seems likely that a spouse must be a U.S. citizen in order to benefit given that citizenship (as opposed to residency or domicile) is required for the estate tax marital deduction to apply.

KPMG observation

One of the current benefits of a charitable remainder trust (CRT) is the ability to transfer appreciated assets into the trust and have the trust sell the assets and reinvest the proceeds without immediate income tax consequences. Because the trust is a tax-exempt entity, the gain is not subject to tax unless and until a distribution is made, allowing 100% of the value of the assets to appreciate further inside the trust for the benefit of the donor and charity. If the proposal became law, a contribution of appreciated assets to a CRT which is set up to provide the minimum required actuarial amount of 10% for the charitable remainderman while the donor retains the other 90%, might cause the donor to realize 90% of the total gain making such contributions far less tax efficient. However, it is unclear whether the definition of transfer will include incomplete gifts or not; if not, then creating a CRT in which the donor retains a 90% interest may still provide income tax benefits. Since charitable lead trusts (CLT) are typically zeroed out—i.e., the value of any remainder for the grantor's children is zero based on the required assumptions—the grantor might be able to exclude 100% of the gain on the appreciated assets used to fund the CLT since that would be the portion attributable to the charitable beneficiary.

The administration's proposal provides an exclusion for tangible personal property such as household furnishings and personal effects (excluding collectibles). In addition, the current principal residence allowance of $250,000 per-person would apply and would be portable (i.e., transferable) to the surviving spouse such that the exclusion is $500,000 for married couples. The current exclusion for capital gain on certain small business stock would also apply.

Finally, the proposal would allow each person a $1 million exclusion for other unrealized capital gains on property transferred by gift or held at death. This lifetime exclusion would be indexed for inflation and would be portable to a surviving spouse (making the exclusion $2 million per couple).

KPMG observation

The proposal includes a few sentences regarding how the deemed realization of gain would affect the recipient's basis in the assets received. While far from clear, it seems to indicate that the recipient generally would hold the assets with a fair market value basis. This would make sense given the deemed sale treatment inherent in the proposal—the recipient should arguably have a "cost" basis as a result. However, the proposal also says that gifted assets shielded by the $1 million exclusion would retain a carry-over basis. It is unclear whether that same rule applies to assets transferred at death that are shielded by the $1 million exclusion or whether they would receive a stepped-up/cost basis nonetheless. In addition, the proposal does not address specifically the basis of assets received by gift or at death that are excluded from the deemed realization rules by virtue of the type of property—e.g., tangible personal property, small business stock, and principal residences. Is the basis of such assets stepped up to fair market value or do recipients only have the transferor's basis? Additional complexities would need to be addressed for partnership interests that are deemed sold upon death or gift if the partnership has or makes an election under section 754 to adjust the basis of partnership assets.

With respect to illiquid assets, the proposal includes two special relief provisions. First, certain family-owned and -operated businesses would not have to pay the tax on the deemed sale until the business was actually sold or ceased to be family-owned and -operated. Second, the tax on illiquid assets (other than such family businesses and publicly traded financial assets) transferred at death would be payable over a 15-year fixed rate payment plan.

KPMG observation

Although the 15-year payment plan provision only appears to apply to transfers at death, the family business deferral provision is more broadly stated such that it may be intended to apply to gifts or bequests of family business interests as well. These relief provisions would need to be significantly expanded upon in order to address all the potential issues they raise. It is possible that the details might resemble parts or all of the current rules regarding the deferral of estate tax attributable to inclusion of closely held business interests in a decedent's estate.

The proposal would be effective for gains on property transferred by gift, and on property owned at death by decedents dying, after December 31, 2021, and on certain property owned by trusts, partnerships, and other non-corporate entities on January 1, 2022.

KPMG observation

The Green Book did not contain any specific proposals addressing the estate, gift or generation-skipping transfer taxes in and of themselves. Thus, at least for the moment, the administration is not proposing changes to the 40% top transfer tax rate or the enhanced lifetime exemption amount (currently $11.7 million per individual). Under current law, the enhanced exemption amount will return to $5 million (indexed for inflation) in 2026.

Tax carried (profits) interests as ordinary income

The administration's budget proposals include a measure to tax carried interests in investment partnerships as ordinary income subject to self-employment taxes for partners whose taxable income (from all sources) exceeds $400,000. The proposal appears to be substantially similar to proposals that were included in a number of the Obama Administration's budget proposals. The proposal would repeal current section 1061 for all taxpayers whose taxable income exceeds $400,000. While not explicit, this phrasing suggests that current section 1061 would continue to apply to taxpayers whose income does not exceed $400,000.

The Green Book generally indicates that the administration's proposal would tax as ordinary income a partner's share of income from an investment services partnership interest (ISPI) in an investment partnership; would require the partner to pay self-employment taxes on such income; and generally would treat gain recognized on the sale of such interest as ordinary. An ISPI generally would be an interest in an investment partnership that is held by a person who provides services to the partnership. A partnership would be an investment partnership only if: (1) substantially all of its assets were investment-type assets (certain securities, real estate, interests in partnerships, commodities, cash or cash equivalents, or derivative contracts with respect to such assets); and (2) over half of the partnership's contributed capital was from partners in whose hands the interests constitute property not held in connection with a trade or business. As with similar past proposals, the administration's proposal provides exceptions for "invested capital," as well as anti-abuse rules applicable to certain "disqualified interests."

As was also the case for similar prior proposals, the Green Book indicates that:

> *…to ensure more consistent treatment with the sales of other types of businesses, the [a]administration remains committed to working with Congress to develop mechanisms to assure the proper amount of income recharacterization where the business has goodwill or other assets unrelated to the services of the ISPI holder.*

This language apparently signals an intention to provide relief from income recharacterization for gain attributable to "enterprise value" associated with a sponsor's business as opposed to its share of carried interest.

Although light on details, the structure of the Green Book proposal is similar to that of the proposed Carried Interest Fairness Act of 2021 **(H.R. 1068).** The rules described in that bill are extremely complex (statute is 44 pages), and the rules provide for results that extend well beyond character conversion- e.g., override nonrecognition on many ISPI disposition transactions and distributions of property with respect to an ISPI, treat income allocated with respect to an ISPI as non-qualifying income for publicly-traded partnerships starting 10 years after the effective date, etc.

The proposal would be effective for tax years beginning after December 31, 2021.

KPMG observation

It appears the proposal would treat all income of an ISPI as ordinary income, thereby eliminating the character benefits that currently exist under section 1061 for section 1231 gains, section 1256 gains, qualified dividends, and long-term capital gains from assets held more than three years.

KPMG observation

A focus on the requirements associated with invested capital would likely become important to managers to ensure that returns on contributed capital are not subject to recharacterization as ordinary income. However, to the extent that capital gains rates are raised as proposed, this distinction becomes less relevant.

KPMG observation

The potential survival of section 1061 for taxpayers with taxable income under $400,000 would result in significant reporting complexities for investment funds for tax years beginning after December 31, 2021 as it is likely that reporting under both carried interest regimes would be required.

KPMG observation

Treating carried interest allocations as ordinary income subject to self-employment taxes may result in some fund managers considering an incentive fee structure. Managers considering a fee structure should consider modeling the impact of the fee structure on the sponsors and investors. Relevant considerations in the modeling exercise include: the characterization of an incentive fee expense as a deduction under section 162 or section 212, the projected timing of incentive allocations compared to fees, the benefit of a deduction under the SECA regime versus the NIIT regime versus the difference in cash flow if paid out as a W-2 wage bonus, whether fees can be subject to clawback if a fund's performance falters and the taxation of such repayments, whether the incentive fee is structured to be section 409A compliant, section 162(m) considerations, potential economic negotiations surrounding who bears the burden of employment taxes, the impact of an additional deduction on other Code provisions such as section 199A or section 163(j), potential capitalization requirements for certain industries, and potential state sourcing considerations. In addition, consideration should be given to whether a fee structure still provides some of the incentivization associated with granting equity interests, and whether there is a significant impact on estate planning.

KPMG observation

While the proposal's treatment of carried interests (for applicable taxpayers) generally results in taxes similar to those imposed on compensation for services, the proposal does not specifically address whether income derived from such interests would be considered services income (i.e., FDAP income) for other purposes of the Code. However, given that the proposal provides that such interests would be subject to self-employment tax, it seems likely that such income would be considered services income generally subject to information reporting and withholding requirements. Accordingly, non-U.S. partners receiving carried interests with respect to services performed in the United States may be subject to Form 1042-S reporting and withholding under FATCA and chapter 3 of the Internal Revenue Code. While this income would also potentially be in scope for Form 1099-NEC reporting, U.S. partners would typically be exempt from reporting in practice based on the chapter 61 exception for amounts reported on Schedule K-1.

Net investment income and Self-Employment Contributions Act taxes

The administration's proposal would make a variety of changes to the NIIT and SECA tax for high-income taxpayers (with AGI in excess of $400,000, **not** indexed for inflation), including subjecting active passthrough business income to either NIIT or SECA tax.

Under current rules, individuals with income greater than $200,000 (or $250,000, in the case of a joint return) are subject to a 3.8% tax on net investment income. NIIT does not currently apply to self-employment earnings. Self-employment earnings and wages are subject to either SECA tax or Federal Insurance Contributions Act (FICA) tax on earnings up to an indexed cap ($142,800, for 2021). These amounts are also subject to a 2.9% Medicare tax that is not subject to any cap and an additional 0.9% Medicare tax is imposed on self-employment earnings of high-income taxpayers, together totaling 3.8%. The administration's proposal would subject all trade or business income of high-income taxpayers to the 3.8% Medicare tax either through NIIT or SECA tax. This would be accomplished in part by expanding the definition of net investment income to include gross income and gain from any trade or business not already subject to employment taxes for high-income taxpayers.

Under current law, a limited partner is subject to SECA tax only to the extent the partner receives guaranteed payments for services. The limited partner's distributive share of income or loss is excluded. The proposal would subject the distributive share of materially participating high-income limited partners to SECA tax and includes similar rules for materially participating LLC members and S corporation shareholders. The material participation rules would apply to individuals who participate in a business in which they are direct and indirect owners. The exemptions from SECA tax provided under current law for income such as rents, dividends, capital gains, and retirement partner income would continue to apply.

The proposal would be effective for tax years after December 31, 2021 and would require the revenue from NIIT to be directed to the Medicare trust fund (also known as the Hospital Insurance Trust Fund) in the same manner as the current revenue from FICA and SECA taxes, instead of the general fund.

KPMG observation

The proposals call for a significant shift from current law on the application of SECA to limited partners. It would apply the limited partner exception only in cases where a limited partner is not a high-income taxpayer or does not materially participate in the activity. The proposal appears to rely on the material participation rules of section 469. These changes, if adopted, likely would have a significant impact on structuring and controls around monitoring of partner activities. For example, the reliance on material participation rules may place a renewed focus on the grouping of activities.

The expansion of SECA to the distributive share of certain S corporation shareholders would also be a significant change. Under current law, the income of S corporation shareholders is subject to employment taxes (FICA) only to the extent of reasonable compensation paid as wages. The distributive share of S corporation income is not currently subject to employment taxes, neither SECA nor FICA. Under the administration's proposal, the distributive share of materially participating high-income shareholders would be subject to SECA and their reasonable compensation paid as wages would continue to be subject to FICA.

The Social Security Old-Age, Survivors, and Disability Insurance (OASDI) program limits the amount of earnings which are subject to taxation at the maximum FICA / SECA rates (i.e., earnings subject to tax at 12.4%, including for purposes of FICA and SECA, are limited to $142,800 in 2021). Under the Green Book proposals, there is no discussion of removing the taxable maximum base through which the OASDI portion is capped. The Biden campaign had previously proposed that all wages and certain partnership income may be subject to the full amount of FICA (12.4%, with employee share of 6.2%) or SECA (12.4%), respectively, for earners making over $400,000.

The expansion of the definition of net investment income to include gross income and gain from any trade or business not otherwise subject to self-employment taxes would impose NIIT on the rental income and gain derived in a trade or business of high-income real estate professionals.

KPMG observation

Under the proposal, while the income of high-income taxpayers may be subject to a 3.8% tax under either SECA or NIIT, the classification as self-employment income as compared to net investment income may still have an impact on the taxpayer's overall tax liability for the year. For example, tax from SECA may be partially deductible, where tax from NII would not. Or, for example, the taxpayer may have offsetting losses from NII or SECA which may be available to utilize against the changes noted above, potentially favoring one classification over another.

Increase the top marginal income tax rate for high earners

The TCJA temporarily reduced the top marginal individual income tax rate from 39.6% to 37% for tax years 2018 through 2025. This reduced rate is set to expire and to revert to 39.6% after December 31, 2025.

For tax year 2021, the 37% rate applies to taxable income over $628,300 for married individuals filing a joint return and surviving spouses, $523,600 for unmarried individuals (other than surviving spouses) and head of household filers, and $314,150 for married individuals filing a separate return.

Proposal

The administration's proposal would increase the top marginal individual income tax rate from its current level of 37% to 39.6% for tax years beginning after December 31, 2021.

If the proposal were enacted as proposed, beginning in tax year 2022 the 39.6% top marginal individual income tax rate would apply to taxable income over $509,300 for married individuals filing a joint return,

$452,700 for unmarried individuals (other than surviving spouses), $481,000 for head of household filers, and $254,650 for married individuals filing a separate return. Under the proposal, the income brackets subject to the top marginal individual income tax rate would be indexed for inflation after the 2022 tax year.

This proposal would be effective for tax years beginning after December 31, 2021.

KPMG observation

The current top marginal individual income tax rate of 37% is set to expire and to revert to its pre-TJCA rate of 39.6% for tax years beginning after December 31, 2025. The administration's proposal would accelerate the date the TCJA's reduced rate is set to expire and revert the rate back to 39.6% for tax years beginning after December 31, 2021. In addition to restoring the top marginal individual income tax rate to its pre-TCJA level, the proposal would lower the top income bracket threshold to the level that was in effect during the 2017 tax year, as adjusted for inflation.

KPMG observation

While the administration's proposal would increase the top marginal individual income tax rate to 39.6%, taxpayers in the highest income tax bracket would still receive the full tax benefit of their itemized deductions. The Green Book does not include Biden's presidential campaign proposals to limit the benefit of itemized deductions for high-income earners, such as capping the tax benefits of itemized deductions at 28% of value and phasing out itemized deductions for taxpayers with income over $400,000.

KPMG observation

The Green Book does not include a proposal to repeal or modify the $10,000 aggregate limitation that was imposed by the TCJA on the itemized deduction for state and local income taxes, property taxes, and sales tax (the "SALT deduction limitation") for tax years 2018 through 2025. Modifying or repealing the SALT deduction limitation has been identified as a high priority issue by some members of Congress and it is possible that the issue may be raised during consideration of legislation this year.

KPMG observation

Investment fund sponsors should evaluate tax distribution provisions both at the fund level and for portfolio companies to ensure required tax distributions would be sufficient to cover cash taxes if the administration's proposals are enacted.

KPMG observation

This proposal would impact the withholding obligations of taxpayers required to withhold under section 1446 of the Code, as the withholding rates under these sections are determined by reference to the top corporate and individual tax rates.

Section 1446 requires foreign and domestic partnerships that have income effectively connected with a U.S. trade or business (or income treated as effectively connected) to pay a withholding tax on the estimated effectively connected taxable income that is allocable to its foreign partners. The withholding rates referenced in section 1446(b)(2) would change under the administration's proposal from its current rate of 37 percent to 39.6 percent for non-corporate partners.

Given that the proposal affects only the top income bracket, we do not currently anticipate changes to the current backup withholding rate of 24 percent.

KPMG observation

While states generally conform to the federal income tax base, each state establishes its own tax rate structure. As a result, the proposed change to the federal marginal rates would not have a direct impact on the tax rates used by states.

Make permanent excess business loss limitation of noncorporate taxpayers

The administration's FY 2022 proposal would make permanent the section 461(l) excess business loss limitation for noncorporate taxpayers. Section 461(l) limits the extent to which passthrough business losses may be used to offset other income. Currently, section 461(l) is set to expire after December 31, 2026.

Section 461(l) was originally enacted as part of the TCJA and was set to sunset along with several other TCJA-related provisions after December 31, 2025. The CARES Act retroactively repealed section 461(l) for tax years beginning prior to January 1, 2021 (i.e., calendar years 2018, 2019, and 2020). ARPA thereafter extended section 461(l) one year until December 31, 2026.

The provision would apply for tax years beginning after December 31, 2026.

KPMG observation

The excess business loss regime was originally established as a sunsetting revenue raising provision which was designed to offset certain tax cuts under the TCJA. The administration's budget proposal would effectively decouple section 461(l) from other sunsetting TCJA-related provisions and convert it into a permanent revenue raising provision.

Regarding state income taxes, the impact of this proposed change on taxpayers, if enacted, would vary across states, depending on how a state conforms to the Code. Fixed-date conformity states would not take into account the changes until action is taken by the state legislature, even if certain of these states have previously updated the state's laws to take into account the TCJA limitation on excess business losses. In contrast, states with rolling conformity to the Code would automatically adopt the proposed changes, if enacted. However, the overall impact of the proposed changes, even in automatic conformity states, would depend on the net operating loss rules used by a specific state, including that state's carryforward period. Some states also make specific adjustments to the excess business loss rules. California, for example, already provides that the business loss limitation will not sunset, even if the federal sunset date is not changed.

KPMG observation

Taxpayers, especially those in the asset management industry, have struggled with uncertainties surrounding the application of section 461(l) and regulations under section 461(l) have not been issued since its passage with the TCJA. To the extent section 461(l) becomes permanent, regulatory guidance should be expected. For example, while the CARES Act provided some clarity around net capital losses in the section 461(l) calculation, questions remain as to whether capital gain on sale of a partnership interest or S corporation stock could be a gain which is attributable to the taxpayer's trade or business for purposes of section 461(l).

Implement a program integrity allocation adjustment and provide additional funding for tax administration

Almost all IRS operating costs are funded by congressional appropriations. Between 2010 and 2020, the IRS's operating budget fell by about 20% in constant dollars. In its proposal to provide additional funding for the IRS, the administration points out that, during that same 10-year period, the IRS needed additional resources to identify and respond to many emerging areas of noncompliance and implement some of the most significant tax legislation in decades.

The administration proposes to establish what it describes as a robust and reliable stream of funding that would enable the IRS to maintain its enforcement functions, expand and improve its compliance programs, and help the agency increase its effectiveness and efficiency. The proposal would provide more than $79 billion of additional funding for the IRS over the 10-year budget window to fund improvements and expansions in enforcement and compliance activities. The additional funding would also allow the IRS to enhance its information technology capability, including the implementation of the proposed financial information reporting regime, and to strengthen taxpayer service.

In support of its proposed increase in IRS funding the Treasury projects that additional funding will yield significant increased revenues as a result of better IRS enforcement, with most of the net increase in revenue coming in the second half of the budget window. Overall, the administration projects that each dollar of additional IRS funding will generate more than three dollars in incremental revenue.

The proposal would direct that additional resources go toward enforcement against those with the highest incomes, rather than Americans with actual income of less than $400,000.

KPMG observation

The prior administration requested—and Congress approved—increased IRS budgets in FY20 and FY21, reversing an almost decade-long decline in IRS appropriations in real terms. The new administration's proposal would significantly accelerate that trend. In the short-run, however, the proposed increase in funding is likely to place a strain on current IRS operations as it recruits, hires, trains and assimilates large numbers of new employees.

KPMG observation

With increased IRS funding and continued implementation of the new partnership audit rules, participants in the asset management industry should expect a continued focus on IRS audit priorities, especially with respect to the areas that are a focus of announced IRS compliance campaigns.

Considerations for portfolio companies, funds, and non-individual investors

Raise the corporate income tax rate to 28%

The TCJA replaced the graduated C corporation income tax rates, which had included a maximum rate of 35%, with a flat rate of 21%. The administration's proposal would increase the flat corporate income tax rate from 21% to 28%. This proposal would be effective for tax years beginning after December 31, 2021. For fiscal year corporations with a tax year that straddles January 1, 2022 (*i.e.*, a tax year beginning in 2021 and ending in 2022), the proposal would apply a tax rate equal to (i) 21% plus (ii) 7% multiplied by the portion of the tax year that occurs in 2022.

KPMG observation

The administration states that this proposal, estimated by Treasury to raise more than $850 billion over 10 years, is an administratively simple way to raise revenue to pay for infrastructure proposals, increase progressivity, and help reduce income inequality. Implicitly recognizing recent studies regarding foreign ownership of U.S. stock, the Green Book argues that a significant share of the revenue estimated to be raised by the proposal would be indirectly borne by foreign investors.

If enacted, the proposal would reverse half of the 14 percentage point reduction in the maximum corporate income tax rate enacted in the TCJA. This would represent a significant increase in the corporate income tax rate (an increase of seven percentage points, or 33%), although the 28% rate would remain significantly below the maximum corporate rate in effect prior to the TCJA as well as the current maximum income tax rate on individuals (which the administration also proposes to increase).

The proposal would "blend" the current and proposed tax rates for fiscal years that begin in 2021 and end in 2022. In general, absent a specific override, existing section 15 also provides for a "blended" tax rate if the effective date of a tax rate change is not the first day of a tax year. Both the proposal and section 15 calculate the "blended" rate based on the number of days in the tax year before and after the effective date of the change; it is not clear whether the proposal is specifically intended to provide for different results than the results that would arise under section 15.

The TCJA had, in connection with the reduction in the maximum corporate income tax rate, reduced the 80% dividends received deduction ("DRD") (for dividends from 20% owned corporations) to 65% and the 70% DRD (for dividends from less than 20% owned corporations) to 50%. The TCJA changes in the DRD rates had maintained a rough parity between the maximum effective corporate tax rate imposed on dividends subject to the DRD before and after the TCJA's change to the corporate tax rate. For example, prior to the TCJA, a $100 dividend received by a corporate taxpayer subject to a 35% tax rate and eligible for the 80% DRD would generally have resulted in ($100 * (1 – 80%)) * 35%, or $7 of tax. Following the TCJA, the same dividend generally results in ($100 * (1 – 65%)) * 21%, or $7.35 of tax. The proposal does not include any similar adjustment to the DRD rates, or to any other provisions (*e.g.*, the reduction of certain tax credits by $0.33 cents for each $1 of excluded cancellation of indebtedness income under section 108(b)(3)(B)) that are (at least implicitly) tied to the corporate income tax rate.

The proposal, if enacted, would represent the second major change to the corporate income tax rate in the past six years. These rate changes can increase the importance of the timing of income and deductions. For example, a corporation's deduction in a 2020 tax year could potentially offset income that was or would be taxed (i) at 35% in a pre-TCJA year under the expanded loss carryback provisions enacted by the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), (ii) at 21% in its 2020 tax year, or (iii) at 28%, if the proposal is enacted and the deduction is carried forward as part of a net operating loss.

KPMG observation

Investment fund structures utilizing corporate blockers should analyze the impact of the potential increase in the corporate tax rate coupled with the scheduled section 163(j) business interest expense limitation transition from 30% of EBITDA to 30% of EBIT.

KPMG observation

As a result of the decrease in the corporate tax rate with the TCJA, many management companies in the asset management industry considered converting from a partnership to a corporation. A potential increase in the corporate tax rate changes the calculus of a potential corporate conversion, but various factors could still make corporate conversion attractive to certain entities. A potential increase to 28% may also provide more certainty around the long-term tax rates that should be used when modeling the long-term impact of a corporate conversion transaction. Taxpayers considering a conversion should also consider the impact of the Accumulated Earnings Tax and Personal Holding Company Tax.

KPMG observation

Investment fund sponsors should evaluate tax distribution provisions both at the fund level and for portfolio companies to ensure required tax distributions would be sufficient to cover cash taxes if the administration's proposed corporate tax rate increase is enacted.

KPMG observation

This proposal would impact the withholding obligations of taxpayers required to withhold under sections 1445 and 1446 of the Code, as the withholding rates under these sections are determined by reference to the top corporate and individual tax rates.

Section 1445 requires buyers of U.S. real property interests to withhold on purchases of sales from foreign persons. Section 1445(e)(1) sets forth the rate that domestic partnerships, trusts, and estates must withhold on income foreign persons earn from the disposition of a U.S. real property interest. Under the administration's proposal, the withholding rate under section 1445(e)(1) would change from its current rate of 21 percent to the proposed corporate tax rate of 28 percent.

Section 1446 requires foreign and domestic partnerships that have income effectively connected with a U.S. trade or business (or income treated as effectively connected) to pay a withholding tax on the estimated effectively connected taxable income that is allocable to its foreign partners. The withholding rates referenced in section 1446(b)(2) would change under the administration's proposal from its current rate of 21 percent to 28 percent for corporate partners.

Impose a 15% minimum tax on book earnings of large corporations

If enacted, the proposal would launch a new corporate minimum tax regime through the imposition of a 15% minimum tax on the worldwide book income for corporations with such income in excess of $2 billion.

KPMG observation

The Green Book states that in a typical year, around 120 companies issue financial statements that report pre-tax net income of $2 billion or more, and that a "significant share" of these firms pay zero income tax or receive tax refunds. Treasury stated in its Made in America Tax Plan report released on April 7, 2021 that about 45 corporations would have paid a minimum book tax liability under the proposal in recent years, and that the average company facing this tax would see an increased minimum tax liability of about $300 million each year.

The proposal does not describe how worldwide pre-tax book income would be determined (*i.e.,* whether a Generally Accepted Accounting Principles (GAAP), international financial reporting standards (IFRS), or some other measurement would be utilized, or what adjustments might be required). However, the proposal would allow a subtraction for "book net operating loss deductions." The "book tentative minimum tax" (BTMT) would be equal to 15% of the worldwide pre-tax book income amount, less general business credits (including R&D, clean energy, and housing tax credits) and foreign tax credits. The book income tax imposed under this new regime would be equal to the excess, if any, of the BTMT over regular tax.

The proposed book minimum tax regime would permit taxpayers to claim a book minimum tax credit (generated by a positive book tax liability) against regular tax in future years to the extent the credit would not cause tax liability to be less than the BTMT determined for that year.

This proposal would be effective for tax years beginning after December 31, 2021, and was estimated by Treasury to generate $148 billion over the 10-year budget window.

The administration's proposal states, consistent with Treasury's previously released report, that the proposed book minimum tax regime would reduce the disparity between income reported by large corporations on their federal income tax returns and the profits reported to investors in financial statements and would serve as a backstop for the proposed new international tax regime (*see also* the **Revise the global minimum tax regime** and the **Replace BEAT with SHIELD rule** sections elsewhere in this report) to collectively ensure that income earned by large multinational corporations is subject to a minimum rate of taxation.

KPMG observation

The structure of the proposed book income tax is reminiscent of the former corporate alternative minimum tax (AMT), both in how the tax is based on the excess of the BTMT over regular tax, and in how a payment of the tax would give rise to a tax credit that could be used against regular tax in future years but not below the BTMT threshold. Moreover, as with the former corporate AMT, the credit provision can be seen as a sort of timing rule that generally would require certain taxpayers to prepay their regular tax.

The proposal lacks key implementation details. As one example, if a large foreign multinational enterprise has a relatively small taxable presence in the U.S. through a domestic subsidiary corporation, it is reasonable to assume that the full weight of the proposed tax on worldwide income might not be levied against the U.S. subsidiary, and that some set of geographically-based allocation rules might be added. As another example, if a foreign-parented group has multiple chains of U.S. subsidiary corporations (or multiple U.S. subsidiary corporations that do not join the same consolidated return), it is unclear whether a form of notional consolidation might be imposed on the U.S. corporations and how the tax might be allocated between the entities. . However, the Green Book's description of the proposal does not mention this as an issue, and does not provide any indication of what mechanism might be utilized to ensure some degree of proportionality.

One fundamental difference between the proposal and the former corporate AMT is that the proposal would allow only certain tax credits—but not tax deductions (other than "book net operating losses")—in computing the BTMT base. Corporations targeted by the proposal include those with a significant amount of their worldwide income reported in one or more jurisdictions with rates lower than the 15% book income tax rate. However, the proposal could also affect large capital-intensive businesses that take advantage of bonus depreciation and immediate expensing enacted under the TCJA in computing taxable income, and companies facing regional variations in their financial performance due to uneven market conditions or uneven pre-tax profitability between their markets. The proposal could reduce the potential cash tax benefits associated with bonus depreciation, which could reduce the incentive to purchase bonus-depreciation-eligible assets. The proposal could also reduce certain buyers' incentive to structure M&A transactions as actual or deemed taxable asset acquisitions.

The proposal could motivate affected corporate taxpayers to convert deductible expenses into tax credits. For example, the proposal could make the elections to claim tax credits as opposed to tax deductions with respect to eligible expenditures (e.g., foreign taxes paid or accrued) more attractive to affected corporate taxpayers. Similarly, the proposal could incentivize affected taxpayers to redirect their investments away from income subject to tax exemption or tax-deferral treatment (*e.g.*, investments in tax-exempt government bonds, qualified opportunity funds, etc.), and towards items that are eligible for tax credits. Over the years, Congress had enacted a number of special exemptions from the former corporate AMT; similar pressure could be presented to exempt various items from the proposed book income tax base.

The Green Book does not contain any guidance with respect to the determination of the new book net operating loss deduction, though it implies a carryforward concept with respect to book losses. Presumably, such a concept would require a determination of the amount of a book loss that would be eligible for carryforward, the potential for a limited carryforward life, mechanisms for tracking and possibly tracing loss carryforwards where an affected corporate group combines with another such group or divides, or where corporations join or leave a particular affected corporate group. Moreover, there is no indication as to whether a book loss carryover might be subject to ownership change limitations of the type that can be imposed on net operating losses under section 382. Similarly, the proposal does not indicate how the book minimum tax credits would be carried forward, how they might be allocated to or among the U.S. corporations in an affected corporate group, whether a U.S. corporation that joins or departs such a group might take its allocable share of the group's credits with it, or whether those credits might be subject to ownership change limitations such as those that can be imposed under section 383 (which had applied with respect to former corporate AMT credits).

A U.S. income tax based on the book income of corporations is not a new idea, and similar proposals have been made from time to time. A version of such a tax was in place from 1987-1989, as a positive AMT preference item in the former corporate AMT regime. That item was added in the Senate as part of the corporate AMT provisions in the Tax Reform Act of 1986, and was accompanied by Finance Committee report language that finds an echo in the Green Book. The 1986 Act had imposed a requirement that the AMT income for corporate taxpayers be adjusted by certain "book income adjustments." In particular, AMT income for corporate taxpayers generally was increased by 50% of the amount by which the corporation's adjusted net book income exceeded its AMT income for the tax year. The 1986 conference agreement limited the Senate proposal by making it applicable only to tax years beginning in 1987, 1988, and 1989, and supplanting it with the "adjusted current earnings" or "ACE" adjustment for tax years beginning after 1989. For purposes of the 1986 provision, adjusted net book income was the income of the taxpayer as shown in financial reports or statements filed with the Securities and Exchange Commission or other federal, state, or local regulators, or provided to shareholders, owners, or creditors. Treasury was authorized to issue regulations to adjust the adjusted book income amount to prevent the omission or duplication of items, including adjustments under section 482 principles, and adjustments where the provision's principles would otherwise be avoided through the disclosure of financial information through footnotes and other supplementary statements.

It remains to be seen what details would be added to the proposal, to the extent it were to move forward in the legislative process. The 1987-1989 book income adjustment, however, can be seen as providing a potential model.

Replace the base erosion anti-abuse tax (BEAT) with the stopping harmful inversions and ending low-tax developments (SHIELD) rule

The administration's proposal would repeal the BEAT imposed by section 59A and replace it with the SHIELD for tax years beginning after December 31, 2022. The stated intent of the proposal is to address concerns regarding erosion of the U.S. corporate tax base more effectively than BEAT, while simultaneously providing a strong incentive for other jurisdictions to adopt the IIR that is currently being developed at the OECD as part of its work on Pillar Two.

SHIELD would disallow deductions to domestic corporations or branches by reference to low-taxed income of entities that are members of the same financial reporting group (including the common foreign parent, in the case of a foreign-parented group) for groups that meet a global annual revenues threshold.

Taxpayers subject to SHIELD

SHIELD would apply to any financial reporting group that (1) includes at least one domestic corporation, domestic partnership, or foreign entity with a U.S. trade or business and (2) has more than $500 million in global annual revenues, as determined based on the group's consolidated financial statement.

A financial reporting group, for these purposes, would be any group of business entities that prepares consolidated financial statements in accordance with U.S. GAAP, IFRS, or another method authorized by regulations. This definition is virtually identical to the definition of financial reporting group for purposes of the proposal to restrict deductions for excess interest of members of financial reporting groups, discussed elsewhere in this report.

KPMG observation

The definition of financial reporting group is entirely different than the aggregate group concept in BEAT and is similar to the definition of an MNE group for country-by-country reporting (CBCR) purposes. It may be prudent to expect that the definition of financial reporting group may conform fully to the CBCR standard – i.e., that a financial reporting group will include groups that would be required to consolidate if the interests in the parent entity were publicly traded.

How that standard applies in the asset management context varies considerably and depends on the specific facts. In many cases investment funds do not consolidate with their underlying portfolio investments, and investment funds generally also do not consolidate with their investors or general partners or managers. In some cases, however, investment funds do consolidate with entities below the fund or investors or managers above the fund. In these situations SHIELD could have a significant impact for funds and their investors, managers, general partners, or underlying investments. SHIELD also could have a significant impact on investment funds or institutional investors (such as pension funds and sovereign wealth funds) that consolidate with leveraged holding companies, blockers, or services companies. A management group also could be a financial reporting group that is subject to SHIELD.

As discussed further below, the proposal would provide authority for Treasury to exempt payments to domestic and foreign investment funds, pension funds, international organizations, or non-profit entities. Unlike the Pillar Two proposal, the administration's proposal does not specifically mention payments to foreign governments, although an exception for foreign governments presumably could be included in regulations. While the grant of regulatory authority suggests that regulations could provide some relief to investment funds and their investors, the regulatory process takes time and it is not entirely clear how those exceptions might apply or the intended scope of the exceptions.

SHIELD does not include BEAT's base erosion percentage threshold, which would significantly expand the scope of the SHIELD as compared with the BEAT. As noted above, the SHIELD revenue threshold is also based on worldwide revenue rather than U.S. revenue, which also would dramatically broaden the scope of taxpayers potentially covered by SHIELD relative to the BEAT. It is worth noting as well that the revenue threshold under SHIELD does not appear to allow for smoothing over multiple years, consistent with the Pillar Two approach. Accordingly, it may be the case that a taxpayer may trip into and out of SHIELD if a year is atypical or if global revenue fluctuates from year-to-year given the nature of its business.

KPMG observation

The OECD's Pillar Two is proposed to apply to groups that have greater than €750 million (or almost $1 billion) of global annual revenue. The choice of a lower global annual revenue threshold for applying SHIELD is interesting given that the U.S. has signaled a willingness to align the rate at which SHIELD is triggered with the rate agreed at the OECD. It is also surprising given that the SHIELD proposal aligns with other more novel features of Pillar Two, such as using financial accounts to measure ETRs and creating deemed payments to low-taxed entities, as discussed later. It is not clear if the revenue threshold deviation is an oversight or is intended to further protect the U.S. tax base. The lower threshold means that non-U.S. headquartered financial reporting groups with U.S. operations and global annual revenue between $500 million and $1 billion may not be subject to a Pillar Two regime generally, but would still be subject to SHIELD.

Conditions for applying SHIELD

If a domestic corporation or branch is a member of an in-scope financial reporting group, SHIELD would disallow certain deductions when both of the following conditions are satisfied: (1) the financial reporting group contains one or more "low-taxed members" and (2) the domestic corporation or branch makes any gross payment to a member of the financial reporting group.

"Low-taxed" members

For purposes of SHIELD, a "low-taxed" member is any financial reporting group member whose income is subject to (or deemed subject to) an ETR (the "SHIELD ETR") that is below a "designated minimum tax rate."

The "designated minimum tax rate" would be the rate agreed under Pillar Two. However, if SHIELD is in effect before an international agreement on Pillar Two is reached, the designated minimum rate would be the proposed rate for GILTI (21%).

KPMG observation

The Pillar Two rate is anticipated to be lower than 21%. The G7 Finance Ministers and Central Bank Governors recently agreed to a Pillar Two rate of at least 15%, although some countries, including Ireland and Hungary, have already publicly expressed opposition to a 15% minimum rate. Legislation enacting SHIELD thus would seem to require some mechanism to provide for a lower rate once agreement on Pillar Two is reached. This could be challenging without having more details about the mechanics of a future Pillar Two consensus.

A financial reporting group member's SHIELD ETR would be determined by taking into account income earned (aggregating related and unrelated party income) and taxes paid or accrued with respect to the income earned in a jurisdiction by financial reporting group members, based on separate or consolidated group financial statements, disaggregated by jurisdiction. Broad authority would be provided to Treasury to address differences (both permanent and temporary) between the relevant income tax and financial accounting bases, and to account for NOLs in a jurisdiction.

KPMG observation

Unsurprisingly, a member's SHIELD ETR is based on an effective rate, rather than nominal statutory rates in the relevant jurisdiction. Pillar Two also relies on effective rates.

KPMG observation

It appears that a member's SHIELD ETR would be computed by aggregating the income earned and the taxes paid or accrued with respect to that income by all financial reporting group members on a jurisdiction-by-jurisdiction basis, rather than on an entity-by-entity basis. This approach is consistent with Pillar Two. No guidance is provided for assigning income and taxes to jurisdictions.

KPMG observation

The SHIELD ETR is computed by dividing "taxes paid or accrued" by "income earned," determined based on financial statements. While "income earned" is defined to refer to financial statement income, rather than taxable income, it is less clear whether "taxes paid or accrued" relies on financial accounting concepts (in which case "taxes paid or accrued" could include, for example, deferred tax liabilities and taxes accrued for uncertain tax positions) or tax accounting concepts such as those found in section 901, although the latter interpretation appears to be the better read.

KPMG observation

While the proposal is not explicit on this point, the language suggests that "taxes paid or accrued" on income earned in a jurisdiction would include not only local country net basis taxes, but also source-jurisdiction withholding taxes imposed on the income and taxes paid by a parent under an IIR or CFC rule.

Payments by a domestic corporation or branch

Provided that the financial reporting group has a low-taxed member (that is, a member with a SHIELD ETR below the designated minimum rate), any *gross* payment by a domestic corporation or branch to *any* other member of the same financial reporting group (including the common foreign parent of any foreign-parented controlled group) generally would trigger a disallowance of some amount of deductions to the domestic corporation or branch.

More specifically, determining the deductions that would be denied under SHIELD is a two-step process. The first step is to determine the amount of payments made (or deemed made) to a low-taxed member of the financial reporting group. For that purpose, a payment made directly to a low-taxed member is subject to SHIELD in its entirety (the "Direct Payments Rule"). In the case of a payment to a member that is not low-taxed, a portion of the payment is deemed to be made to the low-taxed member(s), based on the ratio of the financial reporting group's low-taxed profits over the group's total profits, determined using the group's consolidated financial accounts (the "Indirect Payments Rule"). Importantly, for purposes of this first step (under either the Direct Payments Rule or the Indirect Payments Rule), "payments" are not limited to deductible payments, and instead include all gross payments, including payments included in COGS.

The second step is to deny deductions in an amount equal to the amount of payments made, or deemed to be made, to low-taxed entities, as determined in the first step. The deductions denied are not necessarily related to the payments identified in the first step. If the payment identified in the first step is otherwise deductible, the deduction for the payment would be disallowed under SHIELD. If, however, the relevant payment is not otherwise deductible (e.g., because it is included in COGS), then other deductions, including deductions for payments to unrelated parties, would be disallowed up to the amount of the payment.

KPMG observation

SHIELD's application on the basis of gross payments (whether or not deductible) would deviate from the approach in the OECD's UTPR, which looks to the amount of net intercompany payments when applying its indirect payment rule. Moreover, the proposal does not indicate that any exceptions would apply based on the type of payment. Indeed, if read very broadly, the term "payments" could even include dividends or other non-deductible payments made in respect of a taxpayer's own equity (although it may be hard to believe this result is intended).

KPMG observation

While the text of the proposal suggests that SHIELD could apply to U.S.-parented groups, the language in the "Reasons for Change" introductory section strongly implies that payments to CFCs that are includible in a U.S. shareholder's subpart F or GILTI income would be exempt from SHIELD. If there is such an exemption, presumably SHIELD would only exempt an amount of the payment *to the extent* that it is taken into account in determining a U.S. shareholder's pro rata share of income under subpart F or increases a U.S. shareholder's pro rata share of tested income with respect to the CFC under GILTI. It is unclear whether a similar exception might apply for payments to the extent they are included in a U.S. person's QEF inclusion under the PFIC regime.

KPMG observation

Read literally, the proposal suggests that SHIELD could apply to payments between domestic entities. Specifically, and possibly to avoid treaty discrimination issues, the proposal does not state that a low-tax member must be foreign. Indeed, the proposal would provide authority for Treasury to exempt payments *to domestic and foreign* investment funds, pension funds, international organizations, or non-profit entities, which implies that payments to domestic members of the financial reporting group generally are in scope. Presumably, the statutory language or future regulations promulgated thereunder would (and should) disregard payments made between members of the same U.S. consolidated return group for purposes of SHIELD. For payments between domestic business entities that are members of the same financial reporting group but not the same U.S. consolidated return group, the proposal's description leaves open the possibility that such gross payments could be taken into account. Indeed, because of the Indirect Payments Rule described above, payments between domestic members of the financial reporting group could be treated as payments to a low-taxed group member even if the U.S. income of the group is not low-taxed. In other words, if there is any low-taxed income in the group, domestic-to-domestic payments would be treated as made in part to low-taxed members. Moreover, because the SHIELD ETR is calculated based on financial accounting income, book-tax differences could cause members of the U.S. group to be low-taxed, though as noted above, Treasury would have regulatory authority to address book-tax differences, including NOLs.

KPMG observation

Payments to related RICs and REITS appear to be in scope absent regulations issued under the authority to exclude payments to investment entities. In addition, the inclusion of REITs in the financial reporting group may cause payments made by a REIT to be in scope for SHIELD—which could lead to deduction disallowance not only for those kinds of payments deductible by a typical taxpayer, such as interest expense, but also dividends paid by the REIT.

KPMG observation

The SHIELD's full deduction disallowance under the Direct Payments Rule could result in harsh cliff effects and is a significant (and very taxpayer unfavorable) departure from the OECD's UTPR proposed "top-up" mechanism, which would deny a proportionate amount of a deduction in the payor jurisdiction by reference to the difference between the minimum rate and the Pillar Two ETR of the relevant jurisdiction. For example, assume that a domestic corporation makes a $100x deductible payment directly to a low-taxed member payee. The payee jurisdiction's income is $10x and the taxes paid and accrued are $2.09x, resulting in a SHIELD ETR of 20.9%. Also assume that SHIELD's designated minimum tax rate is 21% (because no agreement is reached on an OECD Pillar Two minimum rate). As proposed, SHIELD would disallow the **entire** $100x deduction regardless of the actual difference between the low-taxed member's SHIELD ETR and the designated minimum tax rate. The potential impact of this rule makes it critical to properly determine a group member's ETR and would heighten the importance of SHIELD due diligence for future acquisitions

Special payment exemption categories

The proposal also would provide authority for Treasury to exempt payments of financial reporting groups that meet a minimum effective level of taxation on a jurisdiction-by-jurisdiction basis, as well as payments to domestic and foreign investment funds, pension funds, international organizations, or non-profit entities. Treasury also would be expected to write rules to take into account payments by partnerships.

KPMG observation

As currently proposed, Pillar Two would exclude certain investment funds, pension funds, and governmental entities, but only if the relevant entity is the ultimate parent of the group. SHIELD's potential exemption for these types of entities is not explicitly conditioned on them being the ultimate parent. It is unclear to what extent any exemption from SHIELD will be coordinated with the exemption under Pillar Two, including the definition of what entities fall within the scope of the exemption.

KPMG observation

While BEAT applies a broad aggregate approach to partnerships, it is not clear how partnerships would be treated under SHIELD, nor whether the treatment of a partnership under foreign law would be relevant to its treatment under SHIELD. For example, assume that a domestic corporation and an unrelated foreign corporation own 40% and 60%, respectively, of the interests in a partnership, and the partnership makes a $100 payment to a foreign member of the domestic corporation's financial reporting group. Is the payment treated as made by the partnership to an entity that is not a member of the partnership's financial reporting group? Or is the payment treated as made by the partners, such that the domestic corporation and foreign corporation are treated as making a payment of $40 and $60, respectively, to the foreign entity? Does it matter whether the partnership itself is a taxpayer in some foreign jurisdiction? Tracking payments under a broad aggregate approach through partnerships would potentially impose a significant burden. It is unclear whether any exemptions (e.g. for small or de minimis ownership in a partnership) will be contemplated.

Delayed effective date

As proposed in the Green Book, SHIELD would not apply until tax years beginning on or after January 1, 2023.

KPMG observation

This proposed effective date would delay implementation of SHIELD until tax years beginning in 2023 and later. The proposal appears to contemplate that BEAT would continue to operate in its current form in the intervening years, because no changes are proposed to BEAT. While the administration does not explain the delayed effective date for SHIELD, presumably it is intended to provide OECD Inclusive Framework members with time to agree to and implement a Pillar Two minimum tax. Additionally, given the complexity and the potentially harsh consequences of running afoul of SHIELD, taxpayers and foreign jurisdictions would need time to digest and conform, and, perhaps equally importantly, Treasury and the IRS would need sufficient time to draft the necessary guidance.

Significant revenue projected

According to the Treasury estimates of the budget proposals, SHIELD is expected to raise over $390 billion in revenue during the 10-year budget window (effectively nine years given the delayed effective date of SHIELD). In contrast, BEAT was expected to raise $150 billion over 10 years when it was enacted as part of TCJA.

Restrict deductions of excessive interest of members of financial reporting groups for disproportionate borrowing in the United States

Very generally, this proposal, similar to a proposal included in the Obama Administration's FY 2017 and FY 2016 Green Books, would limit a taxpayer's deductible interest expense if the taxpayer is a member of a multinational group and is considered to have disproportionate net interest expense as compared to the rest of the group. The proposal would apply only to multinational groups that prepare consolidated financial statements in accordance with GAAP, IFRS, or another method identified under regulations ("financial reporting group"), and would determine the amount of disproportionate interest expense entirely by reference to financial statement metrics, as set forth below.

KPMG observation

The proposal appears targeted at earnings stripping concerns with respect to U.S. subsidiaries of foreign-parented groups. U.S.-parented groups generally would be excluded from the proposal's scope through the treatment of a so-called "U.S. subgroup" as a single member of the financial reporting group. A U.S. subgroup would consist of a U.S. parent company and all U.S. and foreign subsidiaries (i.e., CFCs) that the U.S. parent owns directly or indirectly.

Treasury presumably felt compelled to allow the use of financial reporting information to assess whether a U.S. entity is disproportionately leveraged because it is not practical to require all the earnings or interest expense of a foreign-parented group to be determined using U.S. tax principles. This is also consistent with the SHIELD proposal, which also relies on financial reporting information.

Because the proposal applies to financial reporting groups, its impact on funds would be limited to situations in which the fund consolidates with a manager or general partner, investor, or subsidiary entity. The proposal also could apply to an investor's group if the investor consolidates with a U.S. blocker, holding company, or services entity.

Under the proposal, a member's interest deduction for U.S. tax purposes (both with respect to related and unrelated party debt) would be limited if the member's net interest expense for financial reporting purposes (computed on a separate company basis) exceeds the member's proportionate share of the financial reporting group's net interest expense reported on the group's consolidated financial statements (such excess would be defined as "excess financial statement net interest expense"). A member's proportionate share of the financial reporting group's net interest expense would be determined based on the member's proportionate share of the group's earnings (computed by adding back net interest expense, tax expense, depreciation, depletion, and amortization (i.e., EBITDA) reflected in the financial reporting group's consolidated financial statements.

KPMG observation

The proposal largely follows the prior Obama Green Book proposals. It also is consistent with the OECD BEPS, Action 4 Report (Limiting Base Erosion Involving Interest Deductions and Other Financial Payments), which recommended a profit-based "group ratio" approach that would allow a member of a financial reporting group interest deductions up to the group's net third-party interest/EBITDA ratio. The report indicated in paragraph 117 that an EBITDA-based approach "should be effective in tackling base erosion and profit shifting."

The current Green Book proposal differs significantly from the proposed section 163(n) that was considered, but ultimately rejected, as part of the legislative process for the TCJA in 2017. The Senate version of proposed section 163(n) would have focused on debt-equity ratios rather than EBITDA, and both the House and Senate versions would have significantly impacted U.S.-parented groups because they would have excluded foreign subsidiaries of a U.S. corporation from the computation of the U.S. corporation's relevant ratio.

The Obama and OECD proposals' focus on earnings was motivated, in part, by concerns about profit shifting and a desire to require interest deductions to follow the locations where profit is booked. A member's proportionate share of group EBITDA, however, can be subject to significant year-to-year fluctuation because of variability in the operating conditions within countries. For example, countries have experienced the economic impacts of COVID-19 differently and at different times.

Because it is not realistic for a multinational corporation to continually adjust the capital structures of its members to account for such fluctuations, Treasury, and ultimately Congress, might want to consider a more stable measure to assess proportionality, such as relative assets, as under the version of proposed section 163(n) that was considered in the Senate and the asset-based methodologies for allocating interest expense under current law in Treas. Reg. §§ 1.861-9 and 1.882-5. In this regard, the OECD BEPS Action 4 Report (paragraph 118) noted that an asset-based approach could be more favorable when members of a group incur losses. In addition, we note that both the House and Senate versions of proposed section 163(n) and the BEPS Action 4 Report (paragraph 139) did not require such strict proportionality, allowing instead for a company to deduct up to 110% of its proportionate share of the group's net interest expense, in each case as determined under the relevant measure of proportionality. The BEPS Action 4 Report acknowledged that this uplift would reduce the impact of constraints that could preclude a group from being able to precisely align its net interest expense and EBITDA ratios even in the long-term.

If a member has "excess financial statement net interest expense," a deduction will be disallowed for the member's "excess net interest expense" for U.S. tax purposes. The member's "excess net interest expense" equals the member's net interest expense for U.S. tax purposes multiplied by the ratio of the member's "excess financial statement net interest expense" to the member's net interest expense for financial reporting purposes. Conversely, if a member's net interest expense for financial reporting purposes is less than the member's proportionate share of the net interest expense reported on the group's consolidated financial statements, such excess limitation would be converted into a proportionate amount of excess limitation for U.S. tax purposes and carried forward.

KPMG observation

Assume a foreign parent of a portfolio company group files a consolidated financial statement with a wholly owned U.S. subsidiary, and the parent and subsidiary earn equal amounts of EBITDA. The foreign parent's only borrowing is $100 at 5%, which is on-lent to the U.S subsidiary at 6%. The U.S. subsidiary's net interest expense for financial reporting purposes is $6, and the group's net interest expense reported on the consolidated financial statements is $5 (the $6 of intercompany interest income and expense are eliminated in consolidation). The U.S. subsidiary's proportionate share of the group's $5 of net interest expense is 50% or $2.50. In this case, the US subsidiary's excess net interest expense would be $3.50 ($6-$2.50), and the U.S. subsidiary's current deduction for interest expense would be disallowed based on the amount of its net interest expense for U.S. tax purposes ($6) multiplied by the ratio of its excess net interest expense ($3.50) divided by its net interest expense for financial reporting purposes ($6). Thus, in this example, $3.50, calculated as $6*($3.50/$6), would be disallowed. The disallowed interest would be carried forward as described below.

If a financial reporting group member fails to substantiate its proportionate share of the group's net interest expense for financial reporting purposes, or a member so elects, the member's interest deduction would be limited to the member's interest income plus 10% of the member's adjusted taxable income (as defined under section 163(j)). Regardless of whether a taxpayer computes the interest limitation under the proportionate share approach or using the 10% alternative, any disallowed interest expense could be carried forward indefinitely. It is unclear whether, like section 163(j), such carryforwards would be subject to disallowance under section 382.

KPMG observation

Although the proposal expressly contemplates that "excess limitation would be converted into a proportionate amount of excess limitation for U.S. tax purposes and carried forward *as set forth below*," the proposal then fails to take the topic back up and explicitly address the duration of any such carry forward. By comparison, the Obama-era proposal provided for an indefinite carry forward of disallowed net interest expense and a three-year carryforward for excess limitation. The language describing the three-year carryforward was inexplicably struck from the description of the new proposal without providing an alternative carryforward period. Query whether the intention was to provide for an indefinite carryforward, to eliminate the carryforward entirely, or something else.

This proposal would operate concurrently with section 163(j), meaning that the amount of interest expense a taxpayer could deduct in a tax year would be limited by the more restrictive of the two limitations in that year. Regulations would be authorized to coordinate the two limitations, presumably including ordering rules.

KPMG observation

For tax years beginning on or after January 1, 2022, in applying section 163(j), adjusted taxable income will, absent legislative relief, be calculated without an add-back for depreciation and amortization. If the add-back does sunset as scheduled, section 163(j) will provide for a significantly lower limitation, reducing the impact of this proposal on a taxpayer's interest deduction. The low revenue score ($18.6 billion over 10 years) for this proposal appears to reflect an assumption, consistent with longstanding conventions for revenue estimates, that the scheduled changes to section 163(j) will take effect as per current law. However, a number of legislators in both parties have indicated support for extending the add-back or making it permanent.

The proposal would not apply to financial services entities, and such entities would be excluded from the financial reporting group for purposes of applying the proposal to other members of the financial reporting group. The proposal also would not apply to financial reporting groups that would otherwise report less than $5 million of net interest expense, in the aggregate, on its U.S. income tax returns for a tax year.

Under the proposal, Treasury would be given broad regulatory authority for implementation, including (1) coordinating the application of the proposal with other interest deductibility rules, including the SHIELD, (2) defining interest and financial services entities, (3) permitting financial reporting groups to apply the proportionate share approach using the group's net interest expense for U.S. tax purposes rather than the net interest expense reported in the financial statements, (4) providing for the treatment of pass-through entities, (5) adjusting the application of the proposal to address differences in the functional currency of members, (6) providing for the allocation of a U.S. subgroup's excess net interest expense among the members if they are not all members of a single U.S. consolidated group, and (7) addressing structures with a principal purpose to limit the application of the proposal.

KPMG observation

The proposal might beget a lot of complexity in its implementation in various contexts. Unless the regulatory authority for coordination is exercised with a conscious effort to ease compliance burdens where appropriate, the application of this proposal together with other provisions limiting the deductibility of interest could make compliance remarkably complex with arguably little incremental benefit to the government from that complexity. For example, in the case of a foreign-parented group with one or more CFCs owned directly or indirectly by a U.S. corporation (i.e., a U.S. sandwich structure), a broad panoply of provisions that limit interest expense would be implicated and likely would apply in this order:

First, general debt-equity principles or the section 385 regulations might cause some of the U.S. members' related party debt to be recharacterized as equity. We note, however, that Treasury officials during both the Obama and Biden Administrations observed informally that if a proportionate leverage rule were adopted, the section 385 regulations (i.e., Treas. Reg. §§ 1.385-3 and –4) could be withdrawn in order to facilitate allowing companies to adjust their capital structures to have the desired net proportionate leverage.

Second, the remaining allowable related-party interest deductions would be permitted only to the extent deductible under the cash method of accounting, as provided in Treas. Reg. § 1.267(a)-3(b).

Third, for financial reporting groups with greater than $500 million in global annual revenue, the SHIELD proposal, discussed elsewhere in this report, would disallow interest deductions to the extent the interest income is subject to an effective tax rate that is below a designated minimum rate for tax years beginning after December 31, 2022.

Fourth, section 267A, which limits deductions for certain interest expense paid or accrued in hybrid arrangements, may apply.

Fifth, the proposal and section 163(j) would jointly limit the remaining deductible interest, based on whichever of the two provisions provides the stricter limit. Absent the exercise of regulatory authority, the interest expense deferred or disallowed in (1) through (5) above would still be treated as interest expense of the U.S. subgroup for financial reporting purposes and thus taken into account for purposes of the proposal.

Both the proposal and section 163(j) could apply to limit a CFC's interest expense as well. Under the proposal, a single interest expense limitation would be calculated for U.S. corporations and their CFCs. If the U.S. subgroup, in the aggregate, has excess net interest expense from debt owed outside the subgroup and a portion of such debt is owed by CFCs, it would be necessary to determine the portion of each member's interest to disallow, presumably by determining each member's share of the excess net interest expense. Section 163(j), by contrast, provides separate rules for the disallowance of interest deductions at the U.S. and CFC levels.

Finally, the new proposal relating to section 265 would then apply, which would disallow deductions for amounts allocable to tax-exempt income. For this purpose, tax-exempt income would include dividends from a foreign corporation eligible for a section 245A deduction and the section 250 deduction associated with a GILTI inclusion.

Revise the global minimum tax regime, disallow deductions attributable to exempt income, and limit inversions

Revise the global minimum tax regime

The Green Book contains several reforms aimed at ensuring a taxpayer's global income is subject to a minimum rate of tax. In part, these reforms would be implemented through modifications to the operation of the "global intangible low-taxed income" (GILTI) regime, currently prescribed under section 951A, and through the expansion of section 265, which generally disallows deductions that are attributable to income exempt from U.S. federal income tax. The administration believes these reforms will serve inter-related policy goals: (1) reduce the incentive to locate operations abroad; (2) reduce incentives to locate operations in jurisdictions that impose a low rate of tax; and (3) reduce the extent to which the U.S. subsidizes operations in other jurisdictions by eliminating deductions against U.S. federal income tax liability where the related expenses support foreign operations the gross income from which is wholly or partially exempt from U.S. federal income tax.

Section 951A requires a U.S. shareholder of a CFC to include such CFC's tested income currently in its gross income regardless of whether such income is in fact repatriated to the United States. Under current law, the computation of a U.S. shareholder's GILTI inclusion is made on an aggregate basis across all of its CFCs by reducing the U.S. shareholder's pro rata share of CFC tested income by its pro rata share of CFC tested losses. Additionally, a taxpayer's GILTI inclusion is reduced by its net deemed tangible income return. That net deemed tangible income return is 10% of a CFC's QBAI when the CFC has tested income for the year, reduced by certain interest expense taken into account in determining net CFC tested income. Further, corporate U.S. shareholders are currently allowed a deduction pursuant to section 250 equal to 50% of their GILTI inclusion, subject to an overall taxable income limitation. Any amount of a CFC's tested income that does not result in a GILTI inclusion (on account of the offset of such income that results from QBAI or a tested loss of another CFC) may result in E&P (exempt E&P) that may be repatriated to a 10% corporate shareholder without being subject to U.S. tax if the corporate shareholder qualifies for a DRD under section 245A.

A U.S. corporate shareholder (or, when a section 962 election is made, the applicable individual shareholder) may elect to claim a foreign tax credit for the foreign income taxes that it is deemed to pay pursuant to section 960(d). That section reduces the amount of foreign income taxes the U.S. shareholder would otherwise be deemed to have paid by 20%. Because a taxpayer's foreign tax credit limitation is currently calculated under section 904(d) on an aggregate basis with respect to all of its income in the GILTI basket, a taxpayer may utilize foreign taxes deemed paid by it in a high-tax jurisdiction to offset residual U.S. income tax on tested income earned by a CFC in a jurisdiction with a lower effective tax rate (referred to as "cross-crediting").

Finally, a U.S. corporation may incur deductions in respect of expenses that support, or are otherwise attributable to, its foreign operations, including where the foreign income results in exempt E&P. Currently, there is no direct limitation on the ability to deduct such expenses. Such expenses, however, may affect a taxpayer's foreign tax credit limitation via section 904(b)(4), which currently provides that income and expenses attributable to exempt E&P are not taken into account in determining a taxpayer's limitation in the relevant section 904 basket.

Elimination of QBAI and reduction of the section 250 deduction

The administration's proposal would eliminate QBAI and reduce a corporate U.S. shareholder's section 250 deduction with respect to its GILTI inclusion from 50% to 25%.

KPMG observation

These proposed changes would have a direct impact on funds and their investors only when GILTI inclusions are otherwise required. The changes will indirectly impact funds and investors when U.S. portfolio companies are themselves U.S. shareholders of a CFC.

KPMG observation

The proposal eliminates QBAI because the administration believes that it provides a "perverse" incentive for U.S. multinationals to invest in tangible assets abroad. The elimination of QBAI would increase the amount of a U.S. shareholder's pro rata share of tested income that would be included in its gross income as a GILTI inclusion compared to current law. Further, under the currently existing FDII regime, a taxpayer's section 250 deduction in respect of its FDII is reduced on account of its domestic QBAI. The administration believes that repealing FDII and eliminating the benefit of QBAI in the context of GILTI will reduce tax incentives for investing in tangible property abroad. Of course, many non-tax factors affect the location of investments in tangible property, and to the extent tax does have an impact, the ability to obtain accelerated depreciation at higher rates and other tax incentives may well outweigh the benefit of investing in tangible property abroad due to the treatment of QBAI.

The administration also proposes to reduce the section 250 deduction from 50% to 25%, thus generally increasing the pre-credit effective tax rate for GILTI inclusions. The combination of increasing the corporate tax rate to 28% and decreasing the section 250 deduction to 25% results in doubling the U.S. effective tax rate on GILTI from 10.5% to 21%. The administration believes that narrowing the gap between the U.S. effective rate on domestic income and GILTI inclusions from 10.5% will reduce incentives to locate operations abroad, although a 7% gap would remain. Also, as recognized by the Green Book's SHIELD and anti-inversion proposals, incentives to invert would still remain, in particular if there is ultimately a gap between the U.S. effective rate on GILTI inclusions and the rate for any global minimum tax agreed upon through the OECD's Pillar Two project (or if no agreement on Pillar Two is reached).

In summary, and in particular with respect to U.S. multinational portfolio company structures, there remain opportunities to benefit from foreign ownership of business assets including IP in light of the continuing 7% spread between the U.S. corporate and GILTI tax rates, and to benefit from appropriately inverted ownership structures in light of the potential difference between the proposed GILTI rate of 21% and the rate under Pillar Two as proposed by the OECD (the G7 committed to a rate of at least 15%) . However, opportunities to invert companies are further restricted as described below.

KPMG observation

The administration's proposal makes no reference to the "20% haircut" of section 960(d). Thus, it appears that such reduction in the taxpayer's foreign income taxes deemed paid with a GILTI inclusion would continue to apply. The combined effect of the increase in the U.S. corporate rate, the reduction of the section 250 deduction, and the 20% haircut is that a CFC would be required to pay foreign income taxes on its tested income at an effective rate of 26.25% to eliminate any residual U.S. tax on the U.S. shareholder's GILTI inclusion (determined without regard to U.S. expense allocation and apportionment).

Jurisdiction-by-jurisdiction calculation

The administration's proposal would require that U.S. shareholders compute their GILTI inclusion on a "jurisdiction-by-jurisdiction" basis. This revised computation is a change from what the proposal refers to as the "global averaging" method (*i.e.*, a single GILTI inclusion and a single GILTI FTC limitation). Accordingly, a U.S. shareholder would be required to compute its GILTI inclusion and U.S. federal income tax on such inclusion separately for each jurisdiction in which its CFCs have operations. The U.S. shareholder would also be required to compute a separate GILTI foreign tax credit limitation for each such jurisdiction, thereby precluding the ability to cross-credit its foreign income taxes deemed paid in respect of its GILTI inclusion.

The administration's proposal also provides that a similar jurisdiction-by-jurisdiction approach would apply with respect to a taxpayer's foreign branch basket income. The administration's proposal does not, however, discuss the application of such approach to any other basket (*i.e.*, the general and passive baskets).

The proposal would repeal the high tax exemption for subpart F and GILTI.

The increase in foreign effective tax rate required to generate credits sufficient to eliminate U.S. residual tax on foreign earnings from 13.125% to 26.25% makes it more likely that U.S. multinationals will suffer residual U.S. tax on foreign earnings. The addition of a country by country approach makes it even more likely, as discussed further below.

KPMG observation

Although not explicitly referenced, the administration's proposal to compute GILTI on a jurisdictional basis would seemingly prevent tested losses incurred in one jurisdiction from reducing tested income earned in another jurisdiction. The Green Book explains that "[u]nder the new standard, a U.S. shareholder's global minimum tax inclusion and, by extension, residual U.S. tax on such inclusion, would be determined separately for each foreign jurisdiction in which its CFCs have operations." This language suggests that taxpayers would only benefit from a tested loss to the extent there is offsetting tested income in that same jurisdiction elsewhere in the structure. This change would likely increase the amount of a U.S. shareholder's aggregate GILTI inclusions as compared to current law.

For example, a U.S. shareholder that wholly owns a CFC operating in Germany that earns $110x of tested income and that wholly owns a CFC operating in France that incurs a $100x tested loss would include $110x in its gross income as a GILTI inclusion under the administration's proposal. Such U.S. shareholder's GILTI inclusion under current law would be only $10x (excluding the effect of QBAI). The administration's proposal does not provide for a carryforward of the French CFC's $100 tested loss for use against tested income earned by the French CFC in later tax years.

The proposal does not speak directly to the allowance or disallowance of tested loss carryforwards. Although it is clear such carryforwards are unavailable under current law, this issue takes on heightened significance under the administration's proposed jurisdictional GILTI regime because, absent such an allowance, U.S. shareholders would often be unable to appropriately utilize the economic losses of CFCs. Thus, it can be hoped that this issue might be considered as the proposal moves forward. The "qualified deficit" rule contained in the subpart F regime, which effectively creates a net operating loss (NOL) when a loss arises in connection with a qualified activity, could be modified to include the generation of tested income as a qualified activity (and to operate for this purpose based on taxable income/loss principles rather than based on earnings and profits). In a similar vein, the existing failure of section 960 to grant any credit for taxes paid by a tested loss CFC also seems like it should be revisited in a GILTI regime that operates on a jurisdiction-by-jurisdiction basis.

Even apart from net operating losses, the administration's jurisdiction-by-jurisdiction foreign tax credit limitation proposal could increase the chances for a taxpayer to permanently lose GILTI foreign tax credits. General timing differences between the recognition of income under U.S. principles and the imposition of foreign income tax could be increasingly unfavorable under the administration's proposals. Additionally, separate limitation loss accounts within separate GILTI baskets would cause a loss of foreign tax credits because the administration's proposal does not change the existing exclusion in the section 904(c) carryover rules for GILTI separate limitation taxes. For further discussion of these aspects, please see KPMG's **report**.

The already harsh impact of the disallowance of GILTI foreign tax credit carryforwards under current law would be further exacerbated by the proposal's elimination of the subpart F and GILTI high-tax exception. In a year with a U.S. source NOL, it would generally be favorable for a U.S. shareholder to elect to exclude its high-taxed GILTI under the GILTI high-tax exception. This would preserve the NOL for use against income not taxed at a preferential rate or for which no credits exist to reduce the associated U.S. federal income tax liability. While the ODL rules are intended to mitigate the impact of domestic losses offsetting foreign income, they are particularly ill-suited to that task in the context of the GILTI regime both because of the lack of any carry-forward of GILTI foreign tax credits and because the ODL rules do not restore eligibility for the section 250 deduction. Both concerns could perhaps be ameliorated if an election were made available to waive domestic NOLs to the extent they would otherwise offset GILTI inclusions, along the lines of how section 965(n) operated to prevent NOLs from eroding the value of the deduction under section 965(c). Alternatively, allowing GILTI FTC carryforwards and removing the taxable income limitation on the section 250 deduction would also help address these concerns.

KPMG observation

The administration's proposal does not provide specifics regarding the computation of the jurisdictional GILTI inclusion and leaves open questions regarding how a jurisdictional approach will conform with the FTC limitation. For further discussion of these aspects, please see KPMG's **report**.

A jurisdiction-by-jurisdiction approach for the GILTI foreign tax credit limitation would create a significant compliance burden for taxpayers with CFCs that earn tested income in multiple jurisdictions. For example, a U.S. portfolio company must file a separate Form 1118 for each foreign tax credit limitation basket. Because each jurisdiction in which the portfolio company's CFC earns GILTI and is deemed to pay foreign taxes would create a separate foreign tax credit limitation basket, the number of Form 1118s to be filed for many U.S. portfolio companies would increase significantly. In addition, the rules for creating, maintaining, and recapturing separate limitation losses, overall foreign losses, and the recapture of overall domestic losses could be significantly more burdensome for private equity owned U.S. multinational groups that earn tested income through CFCs organized in multiple foreign countries. This complexity would be compounded to the extent the FTC limitation also applies on a jurisdiction by jurisdiction basis to branch basket income.

The complexity of allocating and apportioning deductions would also increase. For further discussion of these aspects, please see KPMG's **report**.

The administration's jurisdiction-by-jurisdiction approach for GILTI could also significantly increase the amount of previously taxed E&P (PTEP) baskets. This creates reporting complexities (e.g., Form 5471 Schedules E-1 and P would become much lengthier) and other administrative complexities that may make it more difficult to repatriate foreign earnings to U.S. portfolio companies from their foreign subsidiaries. Under current law, there are already 10 PTEP categories for taxpayers to track and maintain, and with a separate jurisdiction-by-jurisdiction approach the amount of PTEP categories would increase significantly. Additionally, there would likely be a substantial increase in the amount of excess limitation accounts to track under section 960(c) with a jurisdiction-by-jurisdiction regime. One of the principal goals of the TCJA was to encourage the repatriation of overseas earnings by making it easier to do so in a tax-free manner (e.g., increased PTEP, section 245A DRD). However, many U.S. portfolio companies have experienced significant difficulties in repatriating earnings post-TCJA due to complexity and uncertainty in rules regarding PTEP distributions. A jurisdiction-by-jurisdiction regime may further exacerbate those difficulties.

Credit for foreign taxes paid under an income inclusion rule

The administration's proposal would allow a foreign-parented U.S. group that owned CFCs to take into account foreign taxes paid by the foreign parent under an Income Inclusion Rule (IIR) that is consistent with the OECD Pillar Two agreement (if a consensus is reached) "with respect to the CFC income that would otherwise be part of the domestic corporation's global minimum tax inclusion." Such foreign taxes would be taken into account by the U.S. group on a jurisdiction-by-jurisdiction basis.

Deductions attributable to income that is exempt from U.S. tax or taxed at preferential rates

Under current law, a taxpayer's expenses are allocated and apportioned to income earned from CFCs pursuant to the expense allocation regulations of Reg. §§ 1.861-8 to 1.861-17 (the "section 861 expense allocation rules"). Under current law, a U.S. shareholder's deductible expenses may be allocated under these rules in part to the separate basket for GILTI and in part to a section 245A subgroup. GILTI inclusions (and the related portion of CFC stock) are characterized in part as exempt income (and assets) under section 864(e)(3) (the exempt asset rule) by reason of the section 250 deduction, meaning that no expenses are allocable to that portion of the taxpayer's GILTI inclusion (or CFC stock generating GILTI inclusions). Expenses allocable to dividends qualifying for the section 245A deduction (or the related portion of stock) are subject to a special rule in section 904(b)(4). Pursuant to that section, such expenses do not reduce foreign source income for purposes of the numerator of the section 904 foreign tax credit limitation, but also do not reduce a taxpayer's "entire taxable income," i.e., the denominator of the section 904 foreign tax credit limitation formula. However, neither the exempt asset rule nor section 904(b)(4) limit a taxpayer's deductions. Instead, both rules *generally* are taxpayer favorable: section 904(b)(4) removes deductions apportioned to a section 245A subgroup from the computation of the taxpayer's foreign tax credit limitation and the exempt asset rule reduces the amount of expenses apportioned to GILTI, thereby causing more deductions to be apportioned to the taxpayer's other section 904 baskets or to its residual U.S. source income.

The Green Book proposes to repeal section 904(b)(4) and expand the application of section 265 to disallow deductions that are allocable to income that is effectively exempt from U.S. tax (e.g., dividends that are eligible for the section 245A deduction) or subject to U.S. tax at a preferential rate through a deduction (e.g., GILTI that is eligible for the section 250 deduction). In the latter case, the proposal could be read literally to suggest that expenses allocable to GILTI inclusions would be denied in full, but the proposal instead might be intended to deny a proportionate amount of deductions allocable to GILTI inclusions based on the percentage of the section 250 deduction with respect to such inclusion. Consistent with this interpretation, the proposal anticipates additional rules to determine the amount of disallowed deductions when only a partial section 245A or section 250 deduction is allowed. Although not clearly stated, it appears that the proposal would rely on the existing section 861 expense allocation rules to allocate and apportion expenses to exempt or preferred income. CFC stock, however, would no longer be treated in part as an "exempt asset" under section 864(e)(3) by reason of the section 250 deduction because a portion of deductions allocated to the section 951A basket would instead be disallowed to the extent a taxpayer qualifies for a section 250 deduction. Similarly, since deductions allocated to a section 245A subgroup would be disallowed, section 904(b)(4) would no longer serve a function and would be repealed.

KPMG example

Consider this illustration of the administration's proposal: USP owns a CFC. USP has a GILTI inclusion with respect to its CFC stock of $100 and USP is entitled to the full deduction under section 250 (i.e., 25%). The CFC also has income that is excluded from GILTI and that is eligible to be paid as a dividend qualifying for a section 245A deduction. The CFC stock is thus characterized in part as an asset generating GILTI inclusions and in part as stock in a section 245A subgroup. USP incurs interest expense of $20, of which $10 is allocable to USP's GILTI inclusion and $5 is allocable to the section 245A subgroup. Under the proposal, USP's interest deduction would be reduced by $7.5, $2.5 of which is on account of the preferential rate of tax imposed on the GILTI inclusion and $5 of which is disallowed because it is allocable to an asset that generates income that is exempt from tax by reason of the section 245A deduction.

KPMG observation

Private equity owned U.S. companies with material foreign operations must carefully model the impact this proposal would have on their tax burden. Interest expense apportioned to the GILTI basket and the section 245A subgroup under Reg. § 1.861-13 would be disallowed as a deduction (to the extent of the partial disallowance for interest expense apportioned to income that is considered offset by the section 250 deduction and the full disallowance for interest expense apportioned to the section 245A subgroup) and any remaining deductible amount would reduce the U.S. portfolio company's limitation in the GILTI basket. If the apportionment of interest expense to the GILTI basket places the U.S. portfolio company in an excess credit position, then both of those results would increase its U.S. tax liability. Thus, the administration's proposals would place an additional premium on the management of the adjusted basis of the U.S. portfolio company's CFC stock.

KPMG observation

Assuming the section 861 expense allocation rules continue to be used to allocate interest expense to CFC stock, the application of section 265 to disallow U.S. deductions would be particularly harsh without also allowing taxpayers to elect to apply rules similar to those contained in former section 864(f), which was repealed earlier this year in H.R. 1319, the American Rescue Plan Act of 2021 (ARPA) without ever being allowed to take effect.

KPMG observation

Without further changes, if enacted, the proposal would magnify the consequences of structural details of how a U.S. portfolio company owns entities that generate tested income, including whether and how much of the U.S. portfolio company's deductions for stewardship and interest are disallowed under section 265 (assuming the rule is implemented using the approach of current Reg. § 1.861-13, which assigns tested income stock to the section 245A subgroup using the taxpayer's "inclusion percentage" as defined in section 960(d)(2)). For example: USP, a domestic corporation that is the parent company of a group of companies held by a private equity fund, owns CFC1 and CFC1 owns CFC2. CFC1 and CFC2 are both CFCs organized in country X. CFC1 has tested income of $100 and CFC2 has a tested loss of $99. Under the current rules, USP's inclusion percentage would be 1% (1/100), meaning that 99% of USP's interest allocable to the CFC1 stock would be assigned to a section 245A subgroup and only 1% would be allocated to the GILTI basket (before considering section 864(e)(3)). However, if instead CFC2 was a disregarded entity of CFC1, USP's inclusion percentage would be 100%, such that all of the interest expense allocable to the CFC1 stock would be assigned to the GILTI basket. Plainly, structural changes could have a significant impact on the inclusion percentage and, consequently, the amount of deductions disallowed under section 265.

For a more detailed discussion of the potential application of these rules, please see KPMG's **report**.

Effective dates

The administration's proposals described above are each proposed to be effective for tax years beginning after December 31, 2021.

KPMG observation

The administration's proposals do not address how the proposals would apply to tax years of CFCs that do not conform to its U.S. shareholder's tax year. This occurs most commonly when CFCs of a U.S. parented portfolio group of companies have made the "one-month deferral" election under section 898 to have a U.S. tax year ending one month earlier than its U.S. parent company. The effective date proposal refers to tax years beginning after December 31, 2021, but does not state clearly whether that is a reference only to the U.S. taxpayer's tax year or also to the CFC's tax year. For example, the administration's proposals would apply to a calendar year U.S. shareholder for its tax year beginning January 1, 2022. It is not clear, however, if the proposals for applying GILTI on a country-by-country basis would apply to such a U.S. shareholder's CFC that uses a tax year ending November 30, 2022, because its tax year ends with or within a tax year of the U.S. shareholder that begins after December 31, 2021, or whether the administration's proposals with respect to such CFC would apply beginning with the CFC's U.S. tax year beginning December 1, 2022.

Subpart F

As noted above, the focus of the administration's proposals concerning subpart F of the Code relate to the GILTI regime. However, consistent with eliminating the GILTI high-tax exception, the administration also would eliminate the high-tax exception for subpart F income. As a result, subpart F income items would be included in subpart F income even if they are subject to a high rate of foreign tax. The proposal would be effective for tax years beginning after December 31, 2021.

KPMG observation

The Green Book provides country-by-country rules only for the GILTI and foreign branch categories. Thus, it appears that taxpayers would be able to continue to cross-credit foreign taxes deemed paid as a result of subpart F inclusions with respect to CFCs in different jurisdictions. Further, as noted above, the Green Book does not propose any relief from the current rules that prevent carrybacks or carryovers of GILTI taxes while allowing subpart F taxes to be carried over (or one year back). These combined considerations broaden the scope of the already-existing phenomenon that foreign income subject to a high rate of tax may be treated more favorably as subpart F income than it would be as tested income. However, the proposed increase in U.S. rates (to 28% for subpart F income and 21% for tested income) would cut the other way—shrinking the universe of income subject to a foreign rate above the corresponding U.S. rate.

Nonetheless, U.S. portfolio companies that earn tested income in several jurisdictions might benefit if such income were instead characterized as subpart F income when its blended effective foreign rate on such earnings is at least 28%, excluding any effect of expense allocation and apportionment. In fact, the rate at which subpart F income becomes more beneficial than GILTI is reduced as more U.S. portfolio group parent company level deductions are allocated and apportioned to such foreign income.

KPMG observation

The divergence in treatment for taxes deemed paid with respect to subpart F inclusions and GILTI inclusions may put increased pressure on rules for allocating and apportioning expenses—and to an even greater extent foreign taxes—as between subpart F income and tested income.

KPMG observation

The favorable treatment of foreign-parented groups subject to IIR rules under Pillar Two for purposes of section 951A (i.e., by taking into account any foreign taxes paid by the foreign parent under an IIR rule), emphasized in the Green Book, would create another significant point of divergence between the GILTI regime and the subpart F regime. Absent relief, subpart F income of a CFC within a foreign-parented group that is subject to an IIR potentially could be subject to double taxation while comparable tested income of the CFC would avoid that result. The Green Book does not explain the policy behind the divergent treatment. The double-tax concern for subpart F income would be mitigated if the jurisdiction of the foreign parent adopts a coordination rule similar to section 3.2.7 of the Pillar Two Blueprint, which would allow U.S. taxes imposed on subpart F inclusions (i.e., traditional CFC income) to be taken into account in determining the effective tax rate (ETR) of the relevant CFC's jurisdiction for purposes of applying an IIR at the foreign parent level. In effect, assuming such a coordination rule in the foreign jurisdiction, subpart F would continue to represent a claim of full taxing jurisdiction for the United States (and the foreign parent's IIR would take into account the subpart F taxes in applying its IIR), while the revised GILTI rules would—consistent with Pillar Two—cede a superior taxing right to the jurisdiction of the foreign parent.

Limit the ability of domestic entities to expatriate

Section 7874 applies to the direct or indirect acquisition of the properties of a domestic corporation or a domestic partnership (each, a "domestic entity") by a foreign corporation (a "foreign acquiring corporation") if, pursuant to a plan or a series of related transactions, the following requirements are satisfied:

- The foreign acquiring corporation directly or indirectly acquires substantially all of the properties directly or indirectly held by a domestic corporation or substantially all of the properties constituting a trade or business of a domestic partnership (each such acquisition, a "domestic entity acquisition");

- After the acquisition, at least 60% of the stock in the foreign acquiring corporation (by vote or value) is held by the former shareholders or the former partners of the domestic entity by reason of holding their stock or interests in the domestic entity (such percentage, the "ownership percentage"); and

- As of the date the acquisition and all related transactions are complete, the expanded affiliated group ("EAG") that includes the foreign acquiring corporation does not have substantial business activities in the foreign country in which, or under the laws of which, the foreign acquiring corporation is created or organized when compared to the EAG's total business activities (the "FSBA requirement").

The FSBA requirement is satisfied if the EAG that includes the foreign acquiring corporation does **not** have at least 25 % of its employee base (by headcount and payroll), tangible asset base, **and** third-party revenue base located or derived in the jurisdiction where the foreign acquiring corporation is created or organized and the foreign acquiring corporation is a tax resident of such jurisdiction.

Under current law, if the above requirements are satisfied and the ownership percentage is less than 80% (a "partial inversion"), then the foreign acquiring corporation is respected as a foreign corporation for U.S. tax purposes, but the domestic entity, U.S. persons related to the domestic entity, and U.S. persons that own shares in the foreign acquiring corporation are subject to certain adverse U.S. tax rules. If the ownership percentage is at least 80% (a "complete inversion"), then the foreign acquiring corporation is treated as a domestic corporation for all purposes of the Code.

The administration's anti-inversion proposal is substantially similar to the anti-inversion proposal in the FY17 Green Book, although the administration's anti-inversion proposal includes a provision related to the treatment of certain distributions, as described below, that was not included in the FY17 Green Book. It also generally aligns with bills proposed this year by Senator Whitehouse and Representative Doggett (collectively, the "Doggett Bill"), Senator Sanders (the "Sanders Bill"), and Senator Durbin (the "Durbin Bill"), with certain significant differences described below. The proposal would expand the scope of section 7874 in three important respects:

Reduction of the complete inversion ownership percentage: The proposal would reduce the requisite ownership percentage for a complete inversion under the current rules from at least 80% to greater than 50% and eliminate the current rules regarding partial inversions. Treasury explained that reducing the ownership percentage for complete inversions is necessary because the partial inversions rules do not sufficiently deter taxpayers from completing partial inversions. Treasury further explained that "[t]here is no policy reason to respect an inverted structure when the owners of a domestic entity retain a controlling interest in the group."

KPMG observation

The proposal to reduce the complete inversion ownership percentage from at least 80% to greater than 50% would apply to many business combinations after which the former domestic entity owners do not retain a controlling interest and would have significant implications for the asset management community. The current section 7874 regulations contain many complex and ambiguous rules that adjust the fraction that is used to compute the ownership percentage, often with surprising and counter-intuitive results. As a result, even under current law, a "merger of equals" involving a foreign acquiring corporation and a domestic target can easily run afoul of the anti-inversion rules. Assuming that the adjustment rules are not eliminated or substantially modified, the proposal to reduce the requisite ownership percentage would increase the number of business combinations subject to section 7874 in which former domestic owners own significantly less than 50% in the resulting entity.

Treasury's rationale for reducing the ownership percentage is repeated verbatim from the FY17 Green Book and seemingly ignores the deterrents to a partial inversion added subsequently by the TCJA. For example, if a foreign acquiring corporation completes a partial inversion after the effective date of the TCJA, dividends paid by the foreign acquiring corporation are not "qualified dividend income" under section 1(h)(11) and thus not taxed at the capital gain rates—a particularly harsh consequence if the foreign acquiring corporation has a significant U.S. investor base. In addition, a partial inversion may result in the recapture of a domestic entity's section 965(c) deduction related to the TCJA "transition tax" (see section 965(l)) and the loss of the cost of goods sold (COGS) exception to the BEAT (see section 59A(d)(4))—although the Green Book proposes to repeal the BEAT.

Changes to the definition of domestic entity acquisition: The proposal would expand the scope of a domestic entity acquisition. As noted above, a domestic entity acquisition occurs under current law when a foreign acquiring corporation directly or indirectly acquires (1) substantially all the properties directly or indirectly held by a domestic corporation, or (2) substantially all the properties constituting a trade or business of a domestic partnership. The proposal would also include as a domestic entity acquisition the direct or indirect acquisition by a foreign acquiring corporation of substantially all of:

- The assets constituting a trade or business of a domestic corporation,
- The assets of a domestic partnership, or
- The U.S. trade or business assets of a foreign partnership.

Further, the proposal would provide that a distribution of stock in a foreign corporation by a domestic corporation or a partnership that represents either (a) substantially all of the distributing entity's assets or (b) substantially all of the distributing entity's assets constituting a trade or business would be treated as a domestic entity acquisition of the distributing entity.

KPMG observation

The change to the definition of domestic entity acquisition would create parity in the way section 7874 applies to acquisitions of the assets of domestic corporations and domestic partnerships. Specifically, the proposal would treat as a domestic entity acquisition a foreign acquiring corporation's direct or indirect acquisition of substantially all the assets of, or substantially all the assets constituting a trade or business of, a domestic corporation or a domestic partnership. Therefore, under the proposal, a foreign corporation's acquisition of the assets of a domestic partnership, if such assets constitute substantially all of the assets of the partnership, would be a domestic entity acquisition, even if the partnership is owned entirely by foreign partners and such assets did not constitute a U.S. trade or business of the foreign partners, in the same manner as if such assets were acquired from a domestic corporation under current law. However, the policy justification for treating domestic corporations and domestic partnerships in a similar manner under section 7874 is questionable. In the case of an acquisition of non-trade or business assets from a domestic corporation, the assets were already subject to U.S. tax. In contrast, the application of section 7874 to a foreign corporation's acquisition of assets of a domestic partnership, with foreign partners and without a U.S. trade or business, would result in creating U.S taxing jurisdiction over assets not previously within the U.S. tax net. The more aggressive treatment of domestic partnerships is particularly odd in light of post-TCJA regulations which drastically reduce the scope of subpart F and GILTI inclusions for CFCs controlled by a domestic partnership and the fact that section 7874 has historically been concerned with the acquiror's ability to avoid such inclusions going forward.

If enacted, the proposal would have significant consequences for otherwise common transactions in the asset management space. For example, checking closed a foreign partnership that held an interest in a U.S. partnership that held assets not engaged in a U.S. trade or business could implicate the inversion rules. Adding foreign corporate blockers to structures holding U.S. partnerships would also be an issue without regard to whether transferors are foreign or domestic persons or entities.

Further, the proposal would expand the definition of domestic entity acquisition to include the direct or indirect acquisition of substantially all the assets constituting a U.S. trade or business of a foreign partnership (effectively treating the foreign partnership as a "domestic entity"), apparently without regard to the identity of the partners of such partnership. There is no similar proposal to apply section 7874 to an acquisition of a U.S. trade or business of a foreign corporation, thus potentially creating disparate treatment between the acquisition of substantially all the assets constituting a U.S. trade or business of a single foreign corporation (not subject to section 7874) and an acquisition of a U.S. trade or business owned by a foreign partnership with foreign corporate partners (subject to section 7874). In addition, the proposal does not provide an exclusion from the definition of domestic entity acquisition for the converse fact pattern, i.e., the acquisition of substantially all the assets constituting a foreign trade or business of a domestic partnership.

This aspect of the proposal would also implicate fact patterns that could easily arise in the asset management space. For example, assume that a foreign partnership holds a debt investment and is not considered in a U.S. trade or business by virtue of section 864(b). Assume that the foreign partnership's debt investment defaults and the foreign partnership receives a U.S. trade or business asset in the workout and does not place it immediately in a blocker. If the foreign partnership were to be checked closed, it would appear that this could implicate the inversion rules, resulting in the foreign partnership being treated as a U.S. corporation. Similarly, if a foreign blocker were inserted between the foreign investors and the foreign partnership, depending on the ownership percentage, the foreign blocker could similarly be implicated by the inversion rules and treated as a U.S. corporation.

To further illustrate the pervasiveness of the proposal into asset management fact patterns, consider the same fact pattern as above but assume the asset received was a U.S. real property interest subject to FIRPTA. If the foreign partnership was considered engaged in a U.S. trade or business and checked itself closed, the inversion rules could be implicated as above, but in addition the foreign partnership could then be a U.S. real property holding corporation (depending on the asset mix). Of course, an attempt at that point to restrict the exposure of investors to holding the stock in a U.S. real property holding company by placing their shares in a non-U.S. blocker corporation could further implicate the inversion rules, causing the foreign blocker to be a U.S. corporation (and likely a U.S. real property holding corporation) as well.

The proposal to treat certain distributions as a domestic entity acquisition was not included in the FY17 Green Book. This proposal could apply to any distribution by a domestic corporation or a partnership (foreign or domestic), including a distribution described in section 311, 331, 332, 355, or 731. Under the proposal, a domestic entity's distribution of the stock of an "old and cold" foreign corporation, if such stock represents substantially all of the assets of the domestic entity, could be treated as an inversion of the domestic entity, even if not preceded by the foreign corporation's direct or indirect acquisition of the assets of the domestic entity pursuant to the same plan as the distribution.

Managed and controlled test: The proposal would add a "managed and controlled" test, under which a domestic entity acquisition would result in a complete inversion irrespective of the associated ownership percentage if each of the following requirements are satisfied:

- Immediately prior to the acquisition, the fair market value of the stock or partnership interests in the domestic entity is greater than the fair market value of the stock in the foreign acquiring corporation (the "substantiality test"),
- After the acquisition, the foreign acquiring corporation's EAG is primarily managed and controlled in the United States, and
- After the acquisition, the foreign acquiring corporation satisfies the FSBA requirement.

KPMG observation

The proposed managed and controlled test would represent a significant departure from the standards of an inversion under current law. Under the managed and controlled test, a domestic entity acquisition could constitute a complete inversion notwithstanding that there is no actual or deemed shareholder continuity between the foreign acquiring corporation and the domestic entity. Thus, a foreign acquiring corporation that acquires a domestic entity in an **all-cash deal** could be treated as a domestic corporation under the managed and controlled test (whether or not the 5% rollover threshold under the "private equity exception" is breached).

- **Managed and controlled test in other proposals.** The FY 2017 Green Book, the Doggett Bill, and the Durbin Bill also included a managed and controlled test. The Sanders Bill did not propose a managed and controlled test for section 7874, but that bill did propose a managed and controlled test under section 7701(a)(4) that would apply for determining the tax residence of any foreign corporation. Because the proposal in the Sanders Bill would apply without regard to whether there has been a domestic entity acquisition, that proposal would be significantly broader than the Green Book proposal. The Doggett Bill also proposed a managed and controlled test for purposes of determining tax residence. While not within the scope of this report, it is worth noting that depending on the scope of such a proposal, these rules could have momentous implications for many common asset management structures.

- **Significant domestic activities and substantiality tests:** The proposed managed and controlled test departs from the Doggett Bill and the Durbin Bill in two important respects. First, the Doggett Bill and the Durbin Bill would both include a requirement that the EAG of the foreign acquiring corporation must not only be managed and controlled in the United States, but it also must have "significant domestic business activities" (the "DSBA requirement"). Whether the DSBA requirement is satisfied would be determined based on the same thresholds that apply for purposes of the FSBA requirement, except the applicable ratios would be measured with regard to the operations of the EAG that includes the foreign acquiring corporation in the United States and only **one** of the four ratios would have to be satisfied. Therefore, the EAG that includes the foreign acquiring corporation would satisfy the DSBA requirement if at least 25 % of its employee base (by headcount or compensation), tangible asset base, **or** third-party revenue base were located or derived in the United States. The managed and controlled test in the Green Book does not include a DSBA requirement, but rather maintains the FSBA requirement. Thus, a foreign acquiring corporation that is managed and controlled in the United States, but whose EAG lacks significant domestic business activities, would not satisfy the managed and controlled test under the Doggett Bill and Durbin Bill, but would satisfy that test under the Green Book proposal if the substantiality test and the FSBA requirement are satisfied.

Second, the proposal's managed and controlled test includes the substantiality test, which provides that a domestic entity acquisition would not be subject to section 7874 unless the domestic entity were larger (by fair market value) than the foreign acquiring corporation. This test would be similar to the substantiality requirement for the exception to the application of section 367(a) to outbound transfers of domestic entity stock in the so-called "Helen of Troy" regulations. Because the Doggett Bill and the Durbin Bill lack a substantiality test, under those proposals, if a foreign acquiring corporation that is managed and controlled in the United States and satisfies the DSBA requirement were to acquire **any** domestic entity, without regard to the relative size or shareholder continuity, the foreign acquiring corporation would become a domestic corporation for U.S. tax purposes. However, the substantiality test in the Green Book may provide limited relief. For example, if a foreign acquiring corporation acquires substantially all of the assets of a single trade or business of a domestic corporation, the substantiality test would appear to compare the fair market value of the foreign acquiring corporation with the fair market value of the entire domestic corporation, rather than just the fair market value of the acquired business. Further, even if a substantiality test is included in the managed and controlled test, it is likely that the substantiality test would incorporate the principles of the NOCD rules as well as other anti-abuse rules contained in the section 7874 regulations or the principles of the "Helen of Troy" regulations. If applied, these rules would generally increase the relative value of a domestic entity for purposes of measuring substantiality.

- **Definition of "managed and controlled":** The proposal does not include a definition of "managed and controlled." Other countries that use a similar standard for determining tax residency generally look to factors such as (1) where senior management is located, (2) where business operations are conducted, (3) legal factors (e.g., jurisdiction of incorporation, location of registered office, etc.), (4) residence of shareholders and directors, and (5) where key decisions are made, with the last factor generally being given the most weight. The Doggett Bill, the Durbin Bill, and the Sanders Bill (the latter with respect to the proposed rule for tax residence) generally defer to the Treasury and IRS to provide regulations that will define "managed and controlled" for purposes of this test. However, each of these bills do direct the regulations to provide that the managed and controlled test is satisfied if substantially all of the executive officers and senior management are based or primarily located within the United States.

Effective date: The proposal to limit a domestic entity's ability to expatriate would be effective for transactions completed after the date of enactment.

KPMG observation

In contrast to the administration's proposed prospective effective date, each of the bills proposed thus far in 2021 would apply retroactively—the Doggett Bill to transactions completed after December 22, 2017 (the date of enactment of the TCJA) and both the Durbin Bill and Sanders Bill to transactions completed after May 8, 2014. Section 7874 itself, enacted on October 22, 2004, was made retroactive to transactions completed after March 4, 2003. Notably, the Green Book proposal does not include an exception for taxpayers that have signed binding agreements to enter into transactions prior to the effective date, nor was any such exception permitted for the original enactment of section 7874 or proposed by any of the bills introduced in 2021. Therefore, notwithstanding the proposed prospective effective date, taxpayers should carefully consider the potential application of these rules to transactions that are completed this year, particularly transactions that may not close until after the date of enactment.

Reform the taxation of fossil fuel income

The proposal would repeal current law's exemption for foreign oil and gas extraction income (FOGEI) from GILTI. It would also amend the definitions of FOGEI and foreign oil related income (FORI) to include income from shale oil and tar sands activity. In conjunction with the jurisdiction-by-jurisdiction approach to section 904 in the GILTI foreign tax credit limitation basket, the inclusion of FOGEI in GILTI is estimated to raise $84.8 billion over the 10-year budget window.

The proposal also amends the regulatory "dual capacity taxpayer" rules. Under section 901, a taxpayer may generally claim a credit against its U.S. income tax liability (subject to the taxpayer's foreign tax credit limitation) for foreign levies that are compulsory payments made under the authority of a foreign jurisdiction to levy taxes and that are not in exchange for a specific economic benefit. Taxpayers that are subject to a foreign levy and receive a specific economic benefit from the foreign levying jurisdiction (i.e., "dual capacity taxpayers") may not claim a foreign tax credit for the portion of the foreign levy paid for the specific economic benefit. Current regulations place the burden of proof on the dual-capacity taxpayer to establish the amount of the levy paid to a foreign government that should be treated as a tax and provide that dual capacity taxpayers may determine the disallowed portion under either a safe harbor method or based on all the relevant facts and circumstances. However, under current regulations, a specific treaty may override the foregoing where it provides that a levy is wholly creditable.

The safe harbor election is effective for the tax year in which made and for all subsequent tax years unless the taxpayer receives permission from the IRS to change to the facts and circumstances method. The election must generally be made with the tax return for the first year to which it applies. The safe harbor method is based on a fixed mathematical formula intended to result in an amount of creditable tax that approximates the amount of generally imposed income tax the taxpayer would have paid if: (1) it was not a dual capacity taxpayer, and (2) if the amount treated as paid in return for the specific economic benefit had been deductible in determining the foreign income tax liability. The safe harbor formula is set out in current regulations as follows:

$$(A - B - C) \times \frac{D}{1 - D}$$

Factors in the formula are:

A. gross receipts,
B. costs and expenses,
C. the amount actually paid under the qualifying levy, and
D. the general income tax rate expressed as a decimal.

If a foreign country does not impose an income tax, the safe harbor method may still be elected, but the (D) factor in the above formula will be the lesser of the foreign dual capacity levy rate or the U.S. corporate rate, proposed to be 28 % under the proposal.

The proposal would eliminate the facts and circumstances method and codify the safe harbor method for a dual capacity taxpayer to determine the portion of a foreign levy paid for a specific economic benefit. The proposal is ambiguous regarding whether a dual capacity taxpayer operating in a foreign country without a generally applicable corporate income tax would be disallowed a foreign tax credit for the entire levy, as included in prior legislative proposals and Senator Wyden's recent proposal. The Biden proposal states that it would "codify" the existing regulatory safe harbor, which would allow creditable foreign taxes based on the U.S. rate if the local jurisdiction does not have a generally applicable corporate income tax. Nevertheless, the Green Book describes the current regulatory safe harbor and the proposal itself only in terms of allowing tax credits based on the generally applicable local corporate tax rate. Similar to the current regulations, the proposal provides that any such rule for determining the amount of a foreign levy paid by a dual capacity taxpayer that qualifies as a creditable tax would not apply to the extent that it conflicts with any U.S. treaty obligation that specifically allows a credit for taxes paid or accrued on certain oil and gas income. Income tax treaties between the United States and the Netherlands, Norway, and the United Kingdom include relevant oil and gas extraction income tax credit provisions. For further context, it should be noted that Senator Wyden's proposed legislation also maintains the exception for treaty overrides.

The proposal would be effective for tax years beginning after December 31, 2021.

For a discussion of these rules, see KPMG's **report**.

Repeal the deduction for foreign-derived intangible income

The administration's proposal would repeal the deduction for foreign-derived intangible income (FDII), effective for tax years beginning after December 31, 2021. The proposal would redeploy the revenue raised by repealing FDII to directly incentivize research and development (R&D) in the United States but does not include a specific proposal for the enhanced R&D incentive.

For further discussion of the FDII repeal proposal, see KPMG's **report** .

KPMG observation

While its repeal was not among the President's campaign proposals, FDII may have become an attractive "target" for the administration for two reasons. First, according to Treasury estimates, repealing FDII would generate significant revenue: $124 billion from 2022-2031. This estimate is notably less than the $224 billion previously estimated by the Joint Committee on Taxation (JCT) for repealing FDII, as reflected in a letter from the JCT to Senator Sanders, dated March 2, 2021 (albeit over a longer 2021-2031 timeframe), but still almost double the original $64 billion price tag for FDII when it was enacted as part of TCJA. In addition, FDII has drawn scrutiny from the OECD as potentially a non-nexus compliant "patent box," and from trading partners as an impermissible export subsidy. Indeed, the administration's April release of its Made in America Tax Plan itself referred to FDII as an "export preference" and indicated that repealing FDII is consistent with the administration's efforts to re-engage in multilateral tax cooperation, particularly at the OECD.

The Green Book justifies repeal, in part, on the grounds that FDII "perversely creates undesirable incentives to locate certain economic activity abroad."

The Green Book also justifies repeal on the grounds that FDII only provides benefits to exporters, as opposed to domestic corporations with primarily domestic sales.

The proposal would repeal FDII for tax years beginning in 2022, without providing any transition relief for long-term transactions entered into in prior years.

Limit foreign tax credits from sales of hybrid entities

A taxpayer that makes a qualified stock purchase of a target corporation (target) is permitted to elect under section 338 (a section 338 election) to treat the stock acquisition as an asset acquisition for U.S. tax purposes through the fiction of deeming the target to sell all of its assets to itself at fair market value. When a section 338 election is made for the purchase of a target CFC, the earnings and profits of the target arising from the deemed asset sale can, in conjunction with the section 1248 recharacterization and section 961 basis adjustment rules, convert what would have been U.S.-source capital gain to the target's U.S. shareholders (USSHs) into foreign-source general basket (or post-TCJA, GILTI) income. Such foreign source income provides limitation under section 904, potentially allowing more utilization of foreign tax credits. Section 338(h)(16) was enacted to counteract this benefit to the target's USSHs, by providing that the results of the deemed asset sale are generally ignored in determining the source and character of any item for purposes of applying the foreign tax credit rules to the seller.

The administration's proposal would apply the principles of section 338(h)(16) to direct or indirect dispositions of an entity that is treated as a corporation for foreign tax purposes but as a partnership or disregarded entity for U.S. tax purposes (specified hybrid entities) and to entity classification changes that are not recognized for foreign tax purposes. Accordingly, for purposes of applying the foreign tax credit rules, the source and character (but not the amount) of any item resulting from the disposition of an interest in a specified hybrid entity or change in entity classification would be determined based on the source and character of an item of gain or loss that the target's USSHs would have taken into account upon the sale or exchange of stock (determined without regard to section 1248). The proposal also contemplates a grant of regulatory authority to carry out the purposes of the new rule, including to extend its application to other transactions "that have a similar effect" and to exempt certain related party transactions. The proposal does not elaborate further, however, on what criteria the administration might have had in mind for either purpose.

The proposal is proposed to apply to transactions that occur after the date of enactment.

KPMG observation

When Congress enacted section 338(h)(16) in 1988, it expressed concern that income from the sale of stock otherwise would be treated as foreign source income for foreign tax credit purposes, even though no foreign country likely would assert taxing jurisdiction over the income (*e.g.*, foreign countries would view the transaction as a sale of stock by a non-resident seller). By extending the principles of section 338(h)(16) to sales of specified hybrid entities and entity classification changes not recognized for foreign tax purposes, the proposal similarly would result in items of income or loss originating from a transaction that likewise avoids tax in the local jurisdiction being treated as originating from a sale of stock for foreign tax credit purposes, thus generally resulting in U.S. source passive income (or foreign source passive income if the owner of the hybrid entity is a CFC).

The proposal continues the trend of limiting the benefits that U.S. taxpayers can achieve as a result of entity classification differences under U.S. and foreign tax rules.

Read broadly, the proposal could also significantly change how the section 367(d) rules apply to "check-the-box" incorporations of hybrid entities. Under current law, section 367(d) generally treats the deemed transfer of intangible property in such transactions as a deemed sale of the intangible property in exchange for payments that are contingent upon the productivity of the property over its useful life. Section 367(d)(2)(C) provides that the resulting inclusions are treated as ordinary income and basketed as if they were royalties from the transferee foreign corporation. If the proposal's reference to "any item" recognized in connection with an entity classification election that is not recognized for foreign tax purposes is applied to the deemed royalties arising under section 367(d), the potential U.S.-source income result would be a stark reversal of current law.

Lastly, the proposal is similar to, and presumably drawn from, earlier proposals by the Obama Administration in the FY 2013-2017 Green Books and in Senator Baucus's 2013 tax reform package. Those earlier proposals would have extended section 338(h)(16) to any covered asset acquisition within the meaning of section 901(m). Given that the current proposal includes a grant of regulatory authority to address similar transactions, there is likely no meaningful difference in scope between these earlier proposals and the new proposal.

Provide tax incentives for locating jobs and business activity in the United States and remove tax deductions for shipping jobs overseas

The administration's proposal would create a new general business credit equal to 10% of eligible expenses incurred in connection with "onshoring" a trade or business, which requires reducing or eliminating a line of business conducted outside the United States and increasing U.S. jobs by starting up, expanding, or otherwise moving the same line of business to the United States. Expenses eligible for the U.S. tax credit would include expenses incurred by a foreign affiliate related to the onshoring. The U.S. Treasury would reimburse U.S. territories for credits provided to their taxpayers.

In addition, the proposal would disallow deductions for expenses incurred in connection with offshoring a U.S. line of business, to the extent it results in a loss of U.S. jobs. Expenses incurred by a CFC in connection with offshoring a U.S. line of business would not be deductible in determining tested income or subpart F income.

For purposes of the proposal, the expenses considered incurred in connection with onshoring or offshoring a line of business are limited solely to expenses associated with relocating the line of business and would not include capital expenditures or costs for severance pay and other assistance to displaced workers.

The proposal would be effective for expenses paid or incurred after the date of enactment.

For additional discussion of the new general business credit, see KPMG's **report**.

KPMG observation

Neither the tax credit nor the expense disallowance would apply unless there is an impact on U.S. jobs from the onshoring or offshoring activity. The proposal does not specify the required degree of such impact or how it would be assessed. The proposal also does not specify the timeframe for assessing whether the same line of business was reduced or eliminated in one location and shifted to or expanded in another location.

Repeal deferral of gain from like-kind exchanges

Under the administration's proposal, the like-kind exchange rules of section 1031 would still be applicable to exchanges of real property held for productive use in a trade or business or for investment. However, the aggregate amount of gain that could be deferred by a taxpayer under the proposal would be limited annually to $500,000 (or $1 million in the case of married individuals filing a joint return).

Any gain realized on an exchange in excess of the $500,000 limitation would be recognized in the tax year in which the property was transferred. Accordingly, if a taxpayer engages in a deferred exchange that straddles two tax years, the gain would be triggered in the first tax year when the relinquished property is transferred rather than the second year when the exchange is completed. This treatment would represent a change from current law, since currently gain recognized in a deferred exchange is generally determined under the installment method.

The proposal would be effective for exchanges completed in tax years beginning after December 31, 2021.

KPMG observation

Although the proposal would not repeal the like-kind exchange rules in their entirety, the proposed cap on the amount of gain that could be deferred for any particular taxpayer to $500,000 annually (or $1 million in the case of married individuals filing a joint return) would likely reduce substantially the number of transactions structured as like-kind exchanges, if the proposal were enacted.

If enacted, the proposal also could be expected to have a significant impact on public REITs, many of which rely heavily on section 1031 to defer gain that otherwise would require a matching distribution in order to avoid an entity-level tax. Section 1031 also plays a prominent role in the business model of a number of open-end real estate funds.

The proposal would also have a significant impact on certain oil and gas properties. Oil and gas unitizations, poolings, and communitizations are treated as like-kind exchanges for federal income tax purposes. Rev. Rul. 68-186, 1968-1 C.B. 354. "[T]he owners of the property have in effect exchanged their separate interests in their leases for undivided interests in the whole, with the result that all the interests of the taxpayer in the unit become one property." H. Rep. No. 88-749 (1963), *reprinted in* 1964-1 (pt. 2) C.B. 125, 216. Note that section 614(b)(3)(A)(i) has a unique supremacy clause regarding the unitization and pooling rules for all purposes of the income tax ("shall be treated for all purposes of this subtitle as one property"). For example, on federal offshore properties a successful well must be drilled in order to enter the unit, there may be multiple unit expansions as additional wells are drilled. Such units would exceed multiple $500,000 amounts multiple times.

Regarding the impact on a taxpayer's income tax bases in various states, because states generally adopt federal income as the starting point for computation of the state income tax base, if a state automatically conforms to the Code and this federal change is made, the state would correspondingly require gain to be recognized from exchanges with amounts exceeding the federal thresholds. Similarly, if the proposed federal rule is enacted, and a state with static conformity updates its rules to follow the federal rule change, then a taxpayer in this state would also recognize gain from exchanges with amounts exceeding the federal thresholds. If a state with static conformity does not update its conformity to the Code, then gain from an exchange may continue to be deferred for the income tax base in that state. The determination of the overall impact on the exchanging parties may vary by state if the properties involved in the exchange are located in multiple states because certain of these states may follow the federal recognition rules while other states may continue to permit the deferral.

The administration proposes to have this change effective for exchanges **completed** in tax years beginning after December 31, 2021. By focusing on the date on which an exchange is completed, the administration's proposal could apply to exchanges that begin prior to January 1, 2022. In particular, the proposal could impact any like-kind exchange that begins on or after July 5, 2021 if the taxpayer relies on the entire 180-day exchange period for completing the exchange.

To the extent sale proceeds held by the qualified intermediary are not reinvested in replacement property, the qualified intermediary may be required under the section 1031 regulations to hold

> those proceeds until the expiration of the 180-day exchange period, thereby causing an exchange to be completed after December 31, 2021. Accordingly, taxpayers entering into an exchange on or after July 5, 2021 may want to carefully consider the identification of the potential replacement properties for the exchange to reduce the possibility that excess sale proceeds remain with the qualified intermediary after December 31, 2021.

Provide federally subsidized state and local bonds for infrastructure

Current and prior law: Tax-exempt and taxable bonds (BABs & QSCBs)

Under current law, state and local governments issue tax-exempt bonds (generally either governmental bonds or qualified private activity bonds) to finance a wide range of projects, including school construction. Among these, the U.S. Department of Transportation can allocate up to $15 billion of private activity bonds for qualified highway and freight transfer facility projects. Most of this allocation has been used.

Under prior law, Build America Bonds (BABs) and Qualified School Construction Bonds (QSCBs) could finance educational facilities. BABs were taxable bonds issued by State and local governments where the federal government either made direct payments to State and local governmental issuers or provided tax credits to bondholders (called "refundable credits") to subsidize a portion of the State and local governments borrowing costs in an amount equal to 35% of the coupon interest on the bonds. QSCBs were bonds for which the bondholders receive taxable interest and federal tax credits.

Proposal: QSIBs and transportation bonds

The proposal notes that aging educational facilities need renovation and new facilities need to be constructed. To address these issues, the proposal would create qualified School Infrastructure Bonds (QSIBs), which would be similar to BABs. There would be a total national QSIB limitation of $50 billion—$16.7 billion each for 2022, 2023, and 2024. Analogous to the operation of BABs, interest on QSIBs would be taxable. Either the bondholders' interest would take the form of a tax credit equal to 100% of the interest on a QSIB, or the bondholders would receive cash from the bond issuer and the federal government would make corresponding direct payments to the bond issuer.

Each State would have to use no less than 0.5% of its total QSIB allocation for outlying areas. Similarly, no less than 0.5% of the QSIB allocation would have to be for schools funded by the Bureau of Indian Education. Further, States could enable local education agencies to issue QSIBs to expand access to high-speed broadband sufficient for digital learning.

For QSIBs issued under the 2022 authorization, States would be required to prioritize allocations to finance projects necessary to reopen schools in line with Centers for Disease Control and Prevention (CDC) guidelines.

The proposal would also expand the category of private activity bonds to address transportation projects. It would increase the amount of such bonds to be allocated by the Secretary of Transportation by an additional $15 billion. The proposal would add public transit, passenger rail, and infrastructure for zero emissions vehicles as qualified activities for which such bonds may be issued. These bonds would not be subject to state private activity bond volume caps.

Both the proposal for QSIBs and the increase in transportation bond volume would be effective beginning with calendar year 2022.

KPMG observation

The QSIBs would provide a higher level of federal subsidy than the BABs. The federal government would pay 100% of the interest on the QSIBs, compared to 35% on the BABs. It is unclear what additional limitations would be placed on state or local education agencies on the use of the QSIBs.

The possible expansion of private activity bonds could result in new opportunities for private investors and investment funds, albeit in a limited range of transportation sectors.

Introduce comprehensive financial account reporting to improve compliance

Currently, reporting requirements for gross receipts exist for only limited types of payments, and there is no reporting requirement for deductible expenses. The proposal cites recent data from the IRS indicating that a tax gap of $166 billion for business income (outside of large corporations) is caused primarily by a lack of information reporting to identify noncompliance without an audit.

The proposal would create a comprehensive financial account information reporting regime under which financial institutions would be required to report data on certain financial accounts on an annual Form 1099 information return. The return would report gross inflows and outflows with a breakdown for physical cash, transactions with a foreign account, and transfers to and from another account with the same owner. The filing requirement would apply to identified business and personal accounts held at financial institutions except for accounts below a low de minimis gross flow threshold of $600 or fair market value of $600. For purposes of this reporting, it is anticipated that the IRS would notify the financial institutions which accounts are subject to the new reporting rules. In general, this would be accounts held by taxpayers that meet certain income thresholds and that earn income that is currently not subject to third party information reporting.

The proposal notes that other accounts similar to financial institution accounts would also be covered, and it highlights that payment settlement entities would file a revised Form 1099-K for all payee accounts, reporting not only gross receipts but also gross purchases, physical cash, payments to and from foreign accounts, and transfer inflows and outflows. The new regime would also cover crypto asset exchanges and custodians.

The Secretary would be given broad authority to issue regulations necessary to implement the proposal, which would be effective for tax years beginning after December 31, 2022.

KPMG observation

The proposal describes many of the concerns and objectives expressed by the administration in a recently released Treasury Report discussing several tax compliance proposals that are part of the American Families Plan. In the Treasury Report, the administration specifically targets partnerships and other complex business structures as a significant source of underreported income. That same report also indicates that new reporting requirements would be imposed on foreign financial institutions.

Significantly, while the proposal "would create a comprehensive financial account information reporting regime," the Treasury Report specifically suggests that the new information reporting rules would build off the existing Form 1099-INT, which is currently furnished to most bank account holders. It is understood that the request to include the expanded account reporting on an existing form came from industry. Specifically, because the new reporting is only required for taxpayers that meet certain income thresholds, which is generally confidential account holder information, financial institutions were concerned about potential impacts to their internal policies if a new form was required. The Treasury Report specified that its recommendations intended to "preserve flexibility" for the IRS to design the appropriate reporting rules for ensuring compliance.

KPMG observation

Despite the statement in the Green Book indicating that this expanded reporting would apply to all business and personal accounts held by a financial institution, additional releases and testimony by the administration regarding this proposal contemplate that the IRS would notify the financial institutions which specific accounts would be subject to the new reporting rules based on the information provided by the taxpayers. In general, this would likely be accounts held by taxpayers that meet certain income thresholds and that earn income that is currently not subject to third-party information reporting.

Enhance accuracy of tax information

Expand the Secretary's authority to require electronic filing for forms and returns

Current law provides that the Treasury Secretary generally may issue regulations that require electronic filing ("e-filing") of returns if a minimum number of returns are filed by the taxpayer during a calendar year. See section 6011(e)(2). Currently corporations that have assets of $10 million or more and that file at least 250 returns (including information returns) per year and partnerships with more than 100 partners are required to e-file their returns.

Under current law, the Secretary generally may not require individuals, estates, and trusts to e-file their income tax returns. See section 6011(e)(1). An exception to this rule is provided in the case of individual income tax returns filed by a tax return preparer that reasonably expects to file over 10 individual income tax returns during the calendar year. See section 6011(e)(3).

The administration indicates that expanding e-filing would help enhance the IRS's selection of returns for audit, facilitate the IRS's compliance risk assessment process, particularly with respect to large or complex business entities and certain types of transactions that may warrant greater scrutiny.

The administration's FY 2022 proposal would require e-filing of returns reporting larger amounts or that are complex business entities, including:

1) Income tax returns of individuals with gross income of $400,000 or more;
2) Income, estate, or gift tax returns of all related individuals, estates, and trusts with assets or gross

income of $400,000 or more in any of the three preceding years;
3) Partnership returns for partnerships with assets or any item of income of more than $10 million in any of the three preceding years;
4) Partnership returns for partnerships with more than 10 partners;
5) Returns of REITs, REMICs, RICs, and all insurance companies; and
6) Corporate returns for corporations with $10 million or more in assets or more than 10 shareholders.

In addition, the proposal would require e-filing of the following forms:

1) Forms 8918, Material Advisor Disclosure Statement;
2) Forms 8886, Reportable Transaction Disclosure Statement;
3) Forms 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons;
4) Forms 8038-CP, Return for Credit Payments to Issuers of Qualified Bonds; and
5) Forms 8300, Report of Cash Payments Over $10,000 Received in a Trade or Business.

Furthermore, the proposal would require return preparers that expect to prepare more than 10 corporation or partnership returns to e-file these returns.

Moreover, the proposal would provide the Secretary with authority to require additional returns, statements, and other documents to be e-filed.

The proposal does not include an effective date.

Improve information reporting for reportable payments subject to backup withholding

In general, a reportable payment is not subject to backup withholding if the payee furnishes a taxpayer identification number ("TIN") to the payor prior to the time payment is made, and in the manner required. Currently, the IRS may only require that the payee furnish their TIN under penalties of perjury with respect to interest, dividends, patronage dividends, and amounts subject to broker reporting. Accordingly, payees of these reportable payments are generally required to provide payors with their TIN using a Form W-9, *Request for Taxpayer Identification Number and Certification,* under penalties of perjury. Payees of other reportable payments subject to backup withholding generally may furnish their TINs without doing so under penalties of perjury. This applies to payments under sections 6041 (payments made in the course of the requester's trade or business for rents, goods (other than bills for merchandise), medical and health care services (including payments to corporations)), 6041A (payments to a nonemployee for services), 6050A (payments to fishing boat crews), 6050N (royalty payments), and 6050W (payments made in settlement of payment card and third party network transactions).

The administration indicates that requiring payees to attest under penalties of perjury to the correctness of their TINs (and other information) on Form W-9 or the equivalent reduces the level of enforcement necessary to ensure information is accurate and increases compliance.

The administration's FY 2022 proposal would treat uniformly all information returns subject to backup withholding. Specifically, the IRS would be permitted to require payees of any reportable payments to furnish their TINs to payors under penalty of perjury.

The proposal would be effective for payments made after December 31, 2021.

KPMG observation

The requirement to collect Forms W-9 for non-financial payments (e.g., payments typically reported on a Form 1099-MISC) would have a significant impact on non-financial entities that are currently able to collect a TIN without obtaining a Form W-9. The proposed rule change does not appear to provide a grandfathering carve-out for payees that have provided their TINs previously, even when the payor has never received a notification from the IRS that one or more TINs were missing from a Form 1099 or do not otherwise match IRS records (often referred to as a "B Notice") with respect to those payees. Instead the Form W-9 documentation requirement would apply to all payments made after December 31, 2021. Therefore, payors making non-financial payments would be required to redocument all U.S. payees that have previously provided a TIN without a Form W-9 if those payees will continue to receive payments after this date. This requirement could lead to an enormous redocumentation effort of existing relationships in a very short period.

Curiously, the proposal would rely solely on penalty of perjury statements to increase the reliability of the TIN information provided, rather than requiring that payors utilize the IRS TIN-matching program, which would guarantee that the name and TIN provided by the payee correctly match the name and TIN combination in IRS records. At a minimum it seems that the administration's increased compliance objectives could be met by permitting payors who wished to elect into TIN-matching to forgo the penalty of perjury requirement when collecting TINs from payees.

Expand broker information reporting with respect to crypto assets

The proposal notes that, despite various sources of third-party information reporting (such as broker reporting and international tax treaties), tax evasion using crypto assets is a growing problem. Focusing on international information exchange, the proposal contemplates that, for the United States to benefit from a global automatic exchange of information with respect to offshore crypto assets and to receive information about U.S. beneficial owners, the United States must reciprocally provide information on foreign beneficial owners of certain entities transacting in crypto assets with U.S. brokers.

To facilitate this global automatic information exchange, the proposal would expand the scope of information reporting by brokers who report on crypto assets to include reporting on certain beneficial owners of entities holding accounts with the broker. The United States could then share such information on an automatic basis with appropriate partner jurisdictions to receive information on U.S. taxpayers reciprocally.

The proposal would require brokers, including entities such as U.S. crypto asset exchanges and hosted wallet providers, to report information relating to certain passive entities and their substantial foreign owners when reporting with respect to crypto assets held by those entities in an account with the broker. It would also require a broker to report gross proceeds and potentially other information related to sales of crypto assets with respect to customers, and, in the case of certain passive entities, their substantial foreign owners.

The proposal would be effective for returns required to be filed after December 31, 2022.

KPMG observation

Crypto assets and transactions have posed several problems in recent years, both technical problems, such as how and when to subject crypto transactions to taxation, and information reporting problems, such as who will report what information and when. The requirements are clear, for example, when crypto currency is used to pay an employee or independent contractor. More vexing are questions relating to whether the sale of crypto currency would be treated as a sale of a security, reportable under section 6045. The proposal addresses part of the information problem by proposing not only to collect information from crypto brokers, but also to share that information with foreign jurisdictions in exchange for information from those jurisdictions on U.S. taxpayers. The scope of this reporting is still unclear (e.g., what are passive entities and their "substantial" foreign owners?), but the scope would likely be broad. Interestingly, this proposal is the limited indication throughout the proposals that, implicitly, the United States has agreed to exchange "reciprocal" information with foreign countries that have entered into Intergovernmental Agreements pursuant to the Foreign Account Tax Compliance Act.

KPMG observation

The proposal does not specify that the current exemption from reporting gross proceeds with respect to a customer that is a non-U.S. person, currently in the Treasury regulations, would be suspended with respect to crypto assets. However, given the Biden Administration's stated goal of providing reciprocity with respect to the reporting of crypto assets, it can be reasonably assumed that the Treasury regulations will be amended to require reporting of direct non-U.S. customers that sell crypto assets as well.

A curious point about the proposal is that it specifies the administration's desire to obtain reporting of customers engaged in transactions with respect to crypto assets and indicates the administration's intent to provide reciprocal reporting to FATCA jurisdiction partners by collecting information on certain foreign owners of passive entities and, we assume, direct foreign customers, who invest in crypto assets. However, the proposal does not specify an intent to obtain reporting with respect to U.S. owners of passive entities that transact in crypto assets in the United States (i.e., note that a "customer" as presently defined in section 6045 would not include the owner of a passive entity that makes the sale). Any reporting obtained through FATCA channels offshore would presumably include reporting with respect to certain U.S owners (either substantial U.S. owners or controlling persons) of passive NFFEs that engage in crypto transactions. Given that, the lack of a coordinating provision to require reporting when a similarly situated passive entity with U.S. owners invests in crypto assets within the United States appears to be an oversight. As the language in the proposal is crafted very broadly and provides only a general outline of the administration's goals, we would anticipate that the statute, if enacted, would address reporting of U.S. owners of passive entities engaging in crypto transactions in the United States as well, particularly given that the proposal is already putting in place the mechanism to require reporting for foreign owners of passive entities engaging in crypto transactions in the United States.

Address taxpayer noncompliance with listed transactions

A "listed transaction" is a transaction that is the same as, or substantially similar to, a transaction identified by the IRS in published guidance as a potential tax avoidance transaction. To date, the IRS has identified more than 35 transactions as "listed transactions." The consequences of a transaction becoming a listed transaction include (i) taxpayers generally are required to disclose their participation in these transactions on Form 8886, *Reportable Transaction Disclosure Statement*, and face penalties for failure to disclose, (ii) taxpayers may face enhanced penalties with respect to underpayments of tax attributable to these transactions, and (iii) persons who are "material advisors" with respect to these transactions are required to maintain independently a list identifying each person with respect to whom the advisor acted as a material advisor and also to provide the list to the IRS upon request.

One of the listed transactions is the so-called *Intermediary Transactions Tax Shelter* (or "midco") transaction, initially identified as such in Notice 2001-16, 2001-1 C.B. 730, clarified in Notice 2008-111, 2008-51 I.R.B. 1299. According to the Green Book:

> *In a typical case, an intermediary entity borrows funds to purchase the stock of the C corporation from the C corporation's shareholders, and the consideration received by the C corporation from the sale of its assets is effectively used to repay that loan. These transactions are structured so that when a C corporation's assets are sold, the C corporation is ultimately left with insufficient assets from which to pay the tax owed from the asset sale. In many cases, the intermediary does not pay the corporate income tax liability and is judgment-proof, frustrating the IRS' ability to collect taxes that are legally owed.*

The first aspect of the proposal would double the general statute of limitations on assessment from three to six years for returns reporting benefits from listed transactions. The taxes that could be assessed during the extended period would not be limited to those attributable to a listed transaction but to the entire return, *i.e.*, the six-year period would apply to any tax attributable to all issues with respect to the income tax return. In addition, for situations where no required disclosure is made on a return of a listed transaction, the assessment period would be increased from one year to three years from the date that disclosure is made or the date that a material advisor has reported the transaction in response to an IRS request. The taxes that could be assessed during the extended period would be limited to those attributable to a listed transaction. The two proposed changes to the statute of limitations on assessment would be effective on date of enactment and are estimated by Treasury to raise approximately $0.6 billion over the 10-year budget window.

The proposal would also impose secondary liability on selling shareholders who directly or indirectly sell or dispose of a 50% or greater interest (a "controlling interest") in the stock of an "applicable C corporation" for payment of the C corporation's income taxes (plus interest, additions, and penalties) to the extent of the sales proceeds received by the shareholders. The liability would arise only after the applicable C corporation was assessed these amounts with respect to any tax year within 12 months before or after the date the stock was sold or disposed of, and only after the applicable C corporation did not pay such amounts within 180 days after assessment. For these purposes, an "applicable C corporation" is a C corporation (or a successor) two-thirds of whose assets are comprised of cash, passive investment assets, or assets that are the subject of a contract of sale (or whose sale has been substantially negotiated on the date that the stock is sold or disposed of). Exceptions would apply to dispositions of publicly-traded C corporation, REIT, or RIC stock, and to C corporation shares acquired by publicly traded acquirers. The proposal would close the tax year of the applicable C corporation as of the later of a disposition of the controlling interest in its stock or on a disposition of all of its assets. In addition, an additional year would be added to the statute of limitations on assessment against the selling shareholders. The secondary liability proposal would be effective for sales of controlling interests occurring on or after April 10, 2013, and is estimated to raise $4.7 billion over the 10-year budget window.

KPMG observation

The first thing to note about the secondary liability proposal is its retroactive effective date—it is proposed to be effective for sales of controlling interests in stock of an applicable C corporation occurring on or after April 10, 2013 (more than eight years prior to the date the proposal was released).

The IRS has aggressively moved to identify midco transactions, and to pursue collections from the selling shareholders under various theories, including transferee liability under section 6901 and state Uniform Fraudulent Conveyance Act laws. The IRS has won a number of these cases in trial and appellate courts, though it has lost some as well. The administration justifies the proposal in part because of what it asserts are mixed results in litigation on factually similar cases. The administration also states that additional time is needed for the IRS to conduct examinations and assess taxes with listed transactions, which can be complex in nature.

While the secondary liability proposal would change the existing rules, the circumstances in which it would apply are similar to those described in Notice 2008-111, though the proposal would cast a somewhat wider net. For example, the Notice addresses situations where at least 80% of a C corporation's stock is sold within a 12-month period, while the proposal would relax the threshold to dispositions of a 50% or greater interest. In addition, the Notice identifies a transaction as a midco transaction only as to those transactional participants who know or have reason to know (or who are deemed to have reason to know) that the corporation's federal income tax obligation with respect to the disposition of its built-in gain assets will not be paid. The proposal, however, lacks a similar knowledge-based limitation. The proposal's exceptions track the safe harbors in the Notice.

Taxpayers who are considering selling or acquiring a controlling interest in an applicable C corporation should consider the potential effects of this proposal in negotiating indemnities and stock purchase agreements. We would expect that potentially affected sellers would want to preclude buyers from engaging in any significant post-acquisition transfers of assets from such a target corporation, to avoid implicating the secondary liability and extended assessment period provisions of this proposal. This, however, could frustrate buyers, who might want flexibility to undertake post-acquisition restructuring of a target to integrate the target's business with its own business.

Modify tax administration rules

Amend the centralized partnership audit regime to address tax decreases greater than a partner's income tax liability

Under the centralized partnership audit regime, the default rule under section 6225 is that the partnership pays an imputed underpayment attributable to adjustments made upon an audit. Under section 6226, a partnership may, however, instead elect to push out the adjustments to its reviewed year partners (i.e., those who were partners during the year to which the adjustment relates). Section 6226(b) generally requires reviewed year partners other than partnerships and S corporations to include on the return for the year that includes the date the push-out statement is furnished to the partner (reporting year) an additional amount of chapter 1 tax. That additional reporting year amount (which may be positive or negative) is equal to the aggregate of the amounts that would result for the reviewed year and all years between the reviewed year and the reporting year if the partnership adjustments were taken into account, and attributes were adjusted, by the partners in those tax years. The proposal explains that if this calculation results in a net decrease in chapter 1 tax, current law treats that net decrease as an amount that can be used by the partners to reduce their reporting year income tax liabilities to zero. The proposal's explanation goes on to state that "any excess of that amount not offset with an income tax due in the reporting year at the partner level does not result in an overpayment that can be refunded. The excess amount cannot be carried forward and is permanently lost."

KPMG observation

The treatment of this excess net decrease arising under the centralized partnership audit regime is not expressly addressed in section 6226(b) or anywhere else in the Code. The view that such a net decrease cannot independently give rise to a refund to the reviewed year partner first arose in the preamble of Treasury regulations under section 6227, relating to Administrative Adjustment Requests (AARs).

As a reason for the proposed change, the explanation notes that the inability for reviewed year partners to receive the full benefit of any reductions in tax resulting from partnership adjustments can lead to "situations where a partner may be viewed as being taxed more for an adjustment made under the centralized partnership audit regime than for one made outside of the centralized partnership audit regime."

KPMG observation

Administrative Adjustment Request adjustments that do not result in an imputed underpayment *must* be pushed out to reviewed year partners, who then must take those adjustments into account generally following the rules under section 6226. This rule, combined with the fact that partnerships subject to the centralized partnership audit rules must file AARs rather than amended returns, means this issue potentially negatively affects many more taxpayers than those subject to audit. As one example, partners of partnerships that file AARs in order to apply new and favorable retroactive legislation and regulations may receive adjustments from the partnership that generate net decreases for those partners exceeding their tax liability for the reporting year. If the partner is unable to claim a refund or to carry back or forward the excess reduction in such a situation, the partner would experience the type of disparity of the type the proposal describes between an adjustment's substantive tax treatment under the centralized partnership audit rules, as compared to its treatment outside of those rules.

The proposal would amend sections 6226 and 6401 of the Code to provide that the amount of the net negative change in tax that exceeds the income tax liability of a partner in the reporting year is considered an overpayment under section 6401 and may be refunded. This proposal would be effective upon enactment.

KPMG observation

If enacted, this proposal would be well received by taxpayers affected by a partnership adjustment under the centralized partnership audit regime. Section 6402(a) authorizes the IRS to credit overpayments against other liabilities and refund any balance.

Interestingly, the description of the proposal in the Green Book seemingly does not align with its description in Table S-6 of the Budget, which appears to contemplate an amendment on this issue that provides for carryovers, rather than full refundability.

The proposal expressly refers only to amending sections 6226 and 6401 and does not mention section 6227, relating to AARs. Section 6227 generally provides that a partnership that files an AAR may push out adjustments to its partners under rules similar to the rules of section 6226. In the case of an AAR adjustment that would not result in an imputed underpayment, the partnership must push out the adjustments to its partners under rules similar to the rules of section 6226 with appropriate adjustments.

The proposal provides only that it is effective upon enactment but does not specify whether the effective date would be applicable for any refund claim made after the date of enactment, or determined by reference to a specific event such as
the filing of an AAR or the filing date of a partner's reporting year return.

Regarding state income taxes, legislation enacting the proposed change would not be anticipated to have a significant impact in the near term at the state level. Since the passage of the centralized partnership audit regime, over fifteen states have enacted legislation related to partnership income adjustments. However, most of these states have not followed various aspects of the federal rules. For example, in most states, both the partnership and its partners still must report changes by adjusting income in the reviewed year, not in the reporting year as under the federal rules. Given that state adjustments are submitted to state revenue authorities by amending returns for the reviewed year, not the reporting year, this change generally would not be anticipated to have a state tax impact in the near term.

Appendix - International tax glossary

BEAT	base erosion anti-abuse tax
BEPS	base erosion and profit shifting
CFC	controlled foreign corporation
COGS	cost of goods sold
CbCR	country-by-country reporting
ETR	effective tax rate
ETI	extra-territorial income
EAG	expanded affiliated group
EBITDA	earnings before interest, taxes, depreciation and amortization
DSBA	significant domestic business activities
FATCA	Foreign Account Tax Compliance Act
FOGEI	foreign oil and gas extraction income
FORI	base erosion anti-abuse tax
FSC	foreign sales corporation
FSBA	foreign substantial business activities
FTC	foreign tax credit
GAAP	Generally Accepted Accounting Principles
G7	The Group of Seven is an intergovernmental organization consisting of Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.
G20	The Group of Twenty is an international forum for the governments and central bank governors from 19 countries and the European Union.
GILTI	global intangible low-taxed income
IIR	income inclusion rule
IFRS	international financial reporting standards
IGA	intergovernmental agreement
JCT	Joint Committee on Taxation
NOL	net operating loss
NOCD	non-ordinary course distribution rule
OECD	Organization for Economic Cooperation and Development
Pillar One	Pillar One of the OECD initiative would provide "market jurisdictions" a new taxing right that goes beyond the arm's-length principle and permanent establishment standard.
Pillar Two	Pillar Two of the OECD initiative would secure a comprehensive agreement on a regime for global minimum taxation that is intended to ensure that all internationally operating businesses pay at least a minimum level of tax on their income in each jurisdiction regardless of where they are headquartered or the jurisdictions in which they operate.
QBAI	qualified business asset investment
R&D	research & development
REIT	real estate investment trust
RIC	regulated investment company
SHIELD	stopping harmful inversions and ending low-tax developments
TLAC	total loss absorbing capacity
UPE	ultimate parent entity
UTPR	undertaxed payments rule
USSH	United States shareholder

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