



Tax provisions in administration's FY 2017 budget proposals

Insurance

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HIGHLIGHTS OF TAX PROPOSALS IN THE ADMINISTRATION'S FISCAL YEAR 2017 BUDGET OF POTENTIAL INTEREST TO INSURANCE INDUSTRY

KPMG has prepared a 103-page [report](#) that summarizes and makes observations about the revenue proposals in the administration's FY 2017 budget. For ease of reference, we have compiled our summaries and observations relating to certain specific industries and topics in separate booklets. This booklet highlights revenue proposals that may be of interest to the insurance industry. Other booklets address proposals relating to other topics.

Background

President Obama on February 9, 2016, transmitted to Congress his fiscal year (FY) 2017 budget, containing the administration's recommendations to Congress for spending and taxation for the fiscal year that begins on October 1, 2016. Although it is not expected that Congress will enact—or even vote on—the president's budget as a whole, the budget represents the administration's view of the optimum direction of spending and revenue policy.

The budget would, according to the White House, reduce the deficit by \$2.9 trillion over 10 years. More than \$900 billion of that reduction would be attributable to changes in the taxation of capital gains and the reduction of tax benefits for upper income individuals. Reduction would also be achieved through changes in the taxation of international business income (which would raise almost \$800 billion in new revenue over 10 years), and from other business tax changes (which would raise approximately \$337 billion).

The president also proposes to impose a new fee on oil that would raise almost \$320 billion over 10 years. That new revenue would be committed to investment in transportation infrastructure as part of a multi-agency initiative to build a “clean” transportation system less reliant on carbon-producing fuels.

The budget also reiterates the president's goal of cutting the corporate tax rate and making structural changes and closing loopholes. In *The President's Framework for Business Tax Reform* (February 2012), he proposed cutting the corporate rate to 28%. The budget does not, however, provide sufficient revenue to offset the cost of such a rate reduction.

Business tax proposals

Many other tax proposals in the FY 2017 budget are familiar, having been included in previous budgets, such as:

- Reforms to the international tax system
- Limiting the ability of domestic entities to expatriate
- Repeal of natural resources production preferences

- Repeal of LIFO and LCM accounting
- Taxation of carried interests in partnerships as ordinary income
- Insurance industry reforms
- Marking financial derivatives to market and treating gain as ordinary income
- Modification of the depreciation rules for corporate aircraft
- Denying a deduction for punitive damages
- Imposing a tax on the liabilities of financial institutions with assets in excess of \$50 billion

Some previous proposals have been modified significantly, such as expanding the types of property subject to a proposed change to the like-kind exchange rules.

In place of the current system of deferral of foreign earnings, the president is again proposing a minimum tax on foreign earnings above a risk-free return on equity invested in active assets. The minimum tax, imposed on a country-by-country basis, would be set at 19% less 85% of the per-country foreign effective tax rate. The new minimum tax would be imposed on a current basis, and foreign earnings could then be repatriated without further U.S. tax liability.

As part of the transition to the new system of taxation of foreign earnings, the budget would also impose a one-time 14% tax on earnings accumulated in CFCs that have not previously been subject to U.S. tax.

Individual (personal) tax revisions

As in the case of businesses, many of the individual (personal) tax proposals in the budget are familiar, including measures that generally would:

- Limit the tax value of certain deductions and exclusions to 28%
- Impose a new minimum tax (the so-called “Buffett Rule”) of 30% of AGI
- Limit the total accrual of tax-advantaged retirement benefits
- Restore the estate, gift, and GST parameters to those in effect in 2009

Among the set of revisions proposed involves reforms to the taxation of capital gains for upper-income taxpayers, which would offset the cost of extension and expansion of tax preferences for middle- and lower-income taxpayers. The highest tax on capital gains would be increased from 23.8% (including the 3.8% net investment income tax) to 28%. In addition, the [Green Book*](#) [PDF 1.85 MB]* indicates that a transfer of appreciated property would generally be treated as a sale of the property. Thus, the donor or deceased owner of an appreciated asset would be subject to capital gains tax on the excess of the asset’s fair market value on the date of the transfer over the transferor’s basis.

*General Explanation of the Administration’s Fiscal Year 2017 Revenue Proposals

The budget also includes a proposal to expand the definition of net investment income to include gross income and gain from any trades or businesses of an individual that is not otherwise subject to employment taxes. The change would potentially affect limited partners and members of LLCs, as well as S corporation owners.

In response to concern that employees in employer-sponsored health plans might unfairly become subject to the Affordable Care Act's excise tax on high-cost plans because they reside in states where health care costs are higher than the national average, the president also proposes modifying the threshold for application of that tax.

Treasury's explanation

The Treasury Department on February 9 released an accompanying explanation of the tax proposals of the budget—Treasury's Green Book* —which describes those proposals in greater detail.

Revenue estimates

This booklet includes the administration's revenue estimates (set forth in the Green Book) of each of the FY 2017 revenue proposals described for the 10-year budget period (2017-2026). These estimates may not reflect interactions among provisions.

The Joint Committee on Taxation ("JCT") has not yet released its revenue estimates of the administration's revenue proposals. The JCT's estimates of specific proposals could be different than the administration's estimates of those proposals. JCT's revenue estimates are the official estimates for tax legislation considered by Congress.

User's guide

\$ = U.S. dollar

% = percent

PATH Act = Protecting Americans from Tax Hikes Act of 2015 (enacted December 18, 2015)

Green Book = Treasury's *General Explanation of the Administration's Fiscal Year 2017 Revenue Proposals*

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Taxation of Insurance Companies

Modify proration rules for life insurance company general and separate accounts

The administration's FY 2017 proposal would change the existing regime for prorating investment income between the "company's share" and the "policyholders' share" for purposes of the dividends-received deduction (DRD). Instead of keying off the policyholders' and company's shares of net investment income, under the proposal the policyholders' share would equal the ratio of an account's mean reserves to mean assets and the company's share would equal one less the policyholders' share.

The provision would be effective for tax years beginning after December 31, 2016.

The administration estimates that this provision would raise approximately \$5.754 billion over the 10-year period.

KPMG observation

Separate account DRD provisions have been included in the administration's FY 2012 through FY 2016 revenue proposals. The FY 2017 proposal is consistent with the proposal in the Camp tax reform bill. The proposal would substantially eliminate the separate account DRD for most life insurance companies that issue variable life insurance and variable annuity products.

Conform net operating loss rules of life insurance companies to those of other corporations

Current law generally allows businesses to carry back a net operating loss (NOL) up to two tax years preceding the tax year of loss (loss year) and to carry forward an NOL up to 20 tax years following the loss year. Life insurance companies, however, that have a loss from operations (LFO)—a life insurance company's NOL equivalent—may carry back the LFO up to three tax years preceding the loss year, and carry forward an LFO up to 15 tax years following the loss year. The administration believes that there is not a compelling reason why losses incurred by life insurance companies should be assigned more favorable tax treatment under the Code than that granted other taxpayers.

The budget proposal would make the rules for carrying over the losses from operations of life insurance companies the same as the rules for net operating losses of other companies: a two-year carryback and a 20-year carryforward.

The change would be effective for tax years beginning after December 31, 2016.

The administration estimates that this provision would raise approximately \$329 million over the 10-year period.

Conform corporate ownership standards

The administration's FY 2017 proposal would amend the "control test" under section 368 to adopt the "affiliation test" under section 1504. Thus, "control" would be defined as the ownership of at least 80% of the total voting power and at least 80% of the total value of stock of a corporation. For this purpose, stock would not include certain preferred stock that meets the requirements of section 1504(a)(4) (certain non-voting, "plain vanilla" preferred stock).

Currently, for tax-free transfers of assets to controlled corporations in exchange for stock, tax-free distributions of controlled corporations, and tax-free corporate reorganizations, "control" is defined in section 368 as the ownership of 80% of the voting stock and 80% of the number of shares of all other classes of stock of the corporation. In contrast, the "affiliation test" under section 1504 for permitting two or more corporations to file consolidated returns is the direct or indirect ownership by a parent corporation of at least 80% of the total voting power of another corporation's stock and at least 80% of the total value of the corporation's stock (excluding certain plain vanilla preferred stock). Several other Code provisions cross-reference and incorporate either the control test or the affiliation test.

The proposal notes that by allocating voting power among the shares of a corporation, taxpayers can manipulate the control test in order to qualify or not qualify, as desired, a transaction as tax-free (for example, a transaction could be structured to avoid tax-free treatment to recognize a loss). In addition, the absence of a value component allows corporations to retain control of a corporation but to "sell" a significant amount of the value of the corporation tax-free. The proposal also notes that a uniform ownership test would reduce complexity currently caused by the two tests.

The proposal would be effective for transactions occurring after December 31, 2016.

The administration estimates that this provision would raise approximately \$296 million over the 10-year period.

KPMG observation

This proposal is consistent with previous changes made to the affiliation test. For example, as noted in the proposal, prior to 1984, the affiliation test required ownership of 80% of the voting stock and 80% of the number of shares of all other classes of stock of the corporation, similar to the control test in section 368. Congress amended the affiliation test in 1984 in response to similar concerns that corporations were filing consolidated returns under circumstances in which a parent corporation's interest in the issuing corporation was being manipulated.

Tax corporate distributions as dividends

The administration's FY 2017 proposal would make several changes to the tax treatment of certain distributions of property by a corporation to its shareholder which, under current law, may not give rise to dividend income. The proposal explains that transactions of this type reduce a corporation's earnings and profits but do not result in a reduction in a corporation's dividend paying capacity, and are therefore inconsistent with a corporate tax regime in which earnings and profits are viewed as measuring a corporation's dividend-paying capacity. The FY 2017 proposal generally targets the same four transactions targeted in the FY 2016 proposal.

Prevent elimination of earnings and profits through distributions of certain stock with basis attributable to dividend equivalent redemptions: Generally, a corporation is required to recognize any gain realized on the distribution of any appreciated property to a shareholder, but does not recognize any loss realized on the distribution of property with respect to its stock. Although the corporation does not recognize a loss, with respect to a distribution of property with basis in excess of fair market value, its earnings and profits are decreased by the adjusted basis (for earnings and profits purposes) of loss property so distributed (but not below zero). Additionally, if an actual or deemed redemption of stock is treated under section 302 as equivalent to the receipt of a dividend by a shareholder, the shareholder's basis in any remaining stock of the corporation is increased by the shareholder's basis in the redeemed stock.

Similar to the administration's FY 2015 and FY 2016 proposals, the FY 2017 proposal would amend section 312(a)(3) to provide that earnings and profits are reduced by the basis in any distributed high-basis stock determined without regard to basis adjustments resulting from actual or deemed dividend equivalent redemptions or any series of distributions or transactions undertaken with a view to create and distribute high-basis stock of any corporation.

The proposal would be effective on the date of enactment.

The administration estimates that this provision would have a negligible revenue effect over the 10-year period.

Prevent use of leveraged distributions from related corporations to avoid dividend treatment: Similar to the administration's FY 2016 proposal, the FY 2017 proposal would treat a leveraged distribution from a corporation to its shareholders that is treated as a recovery of basis as the receipt of a dividend directly from a related corporation to the extent the funding corporation funded the distribution with a principal purpose of not treating the distribution as a dividend from the funding corporation. This proposal revises a previous proposal to disregard a shareholder's basis in the stock of a distributing corporation for purposes of recovering such basis under section 301(c)(2).

This proposal would be effective for transactions occurring after December 31, 2016.

The administration estimates that this provision would raise approximately \$260 million over the 10-year period.

KPMG observation

The title for this section in the FY 2016 proposal included the phrase “related foreign corporations”, while the FY 2017 proposal has omitted the word “foreign.” Other than this change and the change in the effective date, the FY 2016 proposal language and the FY 2017 proposal language are identical.

Treat purchases of hook stock by a subsidiary as giving rise to deemed distributions: If a subsidiary corporation acquires in exchange for cash or other property stock of a direct or indirect corporate shareholder issued by that corporation (hook stock), the issuing corporation does not recognize gain or loss (or any income) under section 1032 upon the receipt of the subsidiary’s cash or other property in exchange for issuing the hook stock.

The administration’s FY 2017 proposal would disregard a subsidiary’s purchase of hook stock for property so that the property used to purchase the hook stock gives rise to a deemed distribution from the purchasing subsidiary (through any intervening entity) to the issuing corporation. The hook stock would be treated as being contributed by the issuer (through any intervening entities) to the subsidiary. The proposal would also grant the Secretary authority to prescribe regulations to treat purchases of interest in shareholder entities other than corporations in a similar manner and provide rules related to hook stock within a consolidated group.

The proposal would be effective for transactions occurring after December 31, 2016.

The administration estimates that this provision would raise approximately \$60 million over the 10-year period.

KPMG observation

The FY 2017 proposal is the same as the FY 2016 proposal. Note that this proposal not only creates a potentially taxable dividend, but also a potential zero tax basis in the hook stock received by the subsidiary.

Repeal gain limitation for dividends received in reorganization exchanges: Section 356(a)(1) currently provides that if, as part of a reorganization, a shareholder receives stock and boot in exchange for its stock in the target corporation, then the shareholder recognizes gain, but not in excess of the boot (the so-called “boot within gain” limitation). Under section 356(a)(2), if the exchange has the effect of the distribution of a dividend, then all or part of the gain recognized by the shareholder is treated as a dividend to the extent of the

shareholder's ratable share of the corporation's earnings and profits (E&P), with the remainder of the gain treated as gain from the exchange of property (generally capital gain).

Similar to the administration's FY 2011 through FY 2016 proposals, the administration's FY 2017 proposal would repeal the "boot within gain" limitation in the case of any reorganization if the exchange has the effect of the distribution of a dividend under section 356(a)(2). In addition, the FY 2017 proposal would align the available pool of earnings and profits to test for dividend treatment with the rules of section 316 governing ordinary distributions.

The proposal would be effective for transactions occurring after December 31, 2016.

The administration estimates that this provision would raise approximately \$628 million over the 10-year period.

KPMG observation

The FY 2017 proposal is the same as the FY 2016 proposal. The FY 2017 proposal refers to the rules under section 316 for purposes of determining the available pool of earnings and profits, while the prior FY 2015 proposal referred to "all of the available earnings and profits of the corporation." It appears that this change may have been intended to clarify that the deemed dividend should follow normal dividend rules and not provide an earnings and profits priority to boot dividends.

Impose a financial fee

The administration proposes to impose a fee on financial entities. The stated purpose of this fee is to reduce the incentive for large financial institutions to leverage, reducing the cost of externalities arising from financial firm default as a result of high leverage. The structure of this fee would be broadly consistent with the principles agreed to by the G-20 leaders.*

*See Staff of the International Monetary Fund, "A Fair and Substantial Contribution by the Financial Sector: Final Report for the G-20" (June 2010).

The fee would apply to both U.S. and foreign banks; bank holding companies; and "nonbanks," such as insurance companies, savings and loan holding companies, exchanges, asset managers, broker-dealers, specialty finance corporations, and financial captives. Firms with worldwide consolidated assets of less than \$50 billion would not be subject to the fee for periods when their assets are below this threshold. According to the Green Book, U.S. subsidiaries and branches of foreign entities that fall into these business categories and that have assets in excess of \$50 billion also would be subject to the fee.

The fee would apply to the "covered liabilities" of a financial entity. Covered liabilities

would be “assets less equity for banks and nonbanks based on audited financial statements with a deduction for separate accounts (primarily for insurance companies).”

The rate of the fee applied to covered liabilities would be seven basis points, and the fee would be deductible in computing corporate income tax. A financial entity subject to the fee would report it on its annual federal income tax return. Estimated payments of the fee would be made on the same schedule as estimated income tax payments.

According to the administration’s estimates, the fee would raise approximately \$111 billion over 10 years and would apply to roughly 100 firms with assets over \$50 billion.

The fee would be effective after December 31, 2016.

KPMG observation

Similar to the administration’s FY 2016 proposal, the proposed fee would apply not just to banks, but would also apply to insurance companies, exchanges, asset managers, broker-dealers, specialty finance companies, and financial captives. This would greatly expand the base of entities subject to the tax. It is unclear how some of these entities (e.g., asset manager and specialty finance companies) would be defined.

The proposal would effectively apply to foreign-headquartered financial institutions, i.e., branches of foreign entities that have assets in excess of \$50 billion, and not just U.S. subsidiaries that meet the asset test. Some financial groups may end up with multiple groups subject to this fee, although the rule would presumably be drafted to avoid double-counting of assets and liabilities.

Increase certainty with respect to worker classification

Under a special non-Code provision (*Section 530 of the Revenue Act of 1978*), the IRS is prohibited from reclassifying an independent contractor to employee status, even when the worker may be an employee under the common law rules, if the service recipient has a reasonable basis for treating the worker as an independent contractor and certain other requirements are met. In addition to providing so-called “Section 530 relief” to service recipients, the 1978 legislation prohibited the IRS from issuing guidance addressing the proper classification of workers.

The administration’s FY 2017 proposal would allow the IRS to require service recipients to prospectively reclassify workers who are currently misclassified. It is anticipated that, after enactment, new enforcement activity would focus mainly on obtaining the proper worker classification prospectively, since in many cases, the proper classification of workers may have been unclear. In addition, the proposal would lift the prohibition on worker classification guidance, with Treasury and the IRS being directed to issue guidance that: (1)

interprets the common law in a neutral manner; and (2) provides narrow safe harbors and/or rebuttable presumptions. Service recipients would be required to give notice to independent contractors explaining how they will be classified and the implications of such classification. Independent contractors receiving payments totaling \$600 or more in a calendar year from a service recipient would be permitted to require the service recipient to withhold federal income tax from their gross payments at a flat rate percentage selected by the contractor. The proposal would also clarify rules with respect to Tax Court jurisdiction in relevant proceedings and make technical and conforming changes to those rules.

The provision (included in previous budget proposals) would be effective upon enactment, but prospective reclassification of those workers covered by Section 530 would not be effective until the first calendar year beginning at least one year after the date of enactment. The transition period could be up to two years for independent contractors with existing written contracts establishing their status.

This provision was included in the administration's FY 2015 and 2016 revenue proposals. The administration estimates that this provision would raise approximately \$10.761 billion over the 10-year period.

KPMG observation

This proposal could result in a significant increase in costs and burdens on U.S. businesses that have service providers currently classified as independent contractors. The reclassification to employee status may have wide-spread implications outside of federal employment taxes and affect such matters as workers compensation, unemployment benefits, pension requirements, and state employment taxes.

Index all civil tax penalties for inflation

The Code currently contains numerous penalty provisions in which a fixed penalty amount was established when the penalty provision was initially enacted. These provisions contain no mechanism to adjust the amount of the penalty for inflation, and thus, these penalties are only increased by amending the Code.

The *Trade Preference Extension Act of 2015*, enacted June 29, 2015, last adjusted certain penalties for inflation—specifically: section 6651 penalty for failure to file a tax return or pay tax; section 6652(c) penalty for failure to file certain information returns; section 6695 return preparer penalty; section 6698 penalty for failure to file a partnership return; section 6699 penalty for failure to file an S corporation return; section 6621 penalty for failure to file correct information returns; and section 6722 penalty for failure to furnish correct payee statements.

The administration's FY 2017 budget proposal would index all civil penalties to inflation (including floors and caps) and round the indexed amount to the next hundred dollars.

The proposal would be effective upon enactment. This provision was included in the administration's 2016 budget proposals.

The administration estimates that this provision would have a negligible revenue effect over the 10-year period.

Repeal special estimated tax payment provision for certain insurance companies

The administration's FY 2017 proposal would repeal section 847, which allows for a deduction for certain special estimated tax payments, effective for tax years beginning after December 31, 2016. Taxpayers may elect to include any balance in the special loss discount account balance as of December 31, 2016, in gross or ratably over a four-year period.

The administration estimates that this provision would have a negligible revenue effect over the 10-year period.

KPMG observation

This provision, which is revenue neutral and is designed to reduce recordkeeping burdens, is consistent with former Ways and Means Chairman Camp 2014 tax reform bill and was included in the administration's FY 2011 through FY 2016 revenue proposals. This provision has long been obsolete.

Taxation of Insurance Products

Expand pro rata interest expense disallowance for corporate-owned life insurance (COLI)

The administration's FY 2017 proposal would repeal the section 264(f)(4)(A)(ii) exception from the overall section 264(f) pro rata interest expense disallowance rule for life insurance, annuity, and endowment contracts covering employees, officers, or directors of a business that is the owner or beneficiary of the contracts. The proposal would leave intact the section 264(f)(4)(A)(i) exception for contracts covering 20% owners of the business that owns the contract.

The proposal would apply to contracts issued after December 31, 2016, in tax years ending after that date. For this purpose, any material increase in the death benefit or other material change in the contract would cause the contract to be treated as a new contract, except in the case of a master contract, for which the addition of covered lives would be treated as a new contract only with respect to the additional covered lives.

The administration estimates that this provision would raise approximately \$7.144 billion over the 10-year period.

Modify rules that apply to sales of life insurance contracts

The administration's FY 2017 proposal would require a person or entity who purchases an interest in an existing life insurance contract with a death benefit equal to or exceeding \$500,000 to report the purchase price, the buyer's and seller's taxpayer identification numbers (TINs), and the issuer and policy number to the IRS, to the insurance company that issued the policy, and to the seller.

Upon the payment of any policy benefits to the buyer, the insurance company would be required to report the gross benefit payment, the buyer's TIN, and the insurance company's estimate of the buyer's basis to the IRS and to the payee.

The proposal also would modify the transfer-for-value rule so that certain exceptions to that rule would not apply to buyers of policies, i.e., by eliminating the existing exception to transfer-for-value for sales of policies to a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer. The exception to the transfer-for-value rule would continue to apply to transfers to the insured, and would apply also to transfers to a partnership or corporation that is at least 20% owned by the insured.

The provision would apply to sales or assignments of interests in life insurance policies and payments of death benefits in tax years beginning after December 31, 2016.

The administration estimates that this provision would raise approximately \$506 million over the 10-year period.

KPMG observation

This provision was designed to address life settlement transactions. The proposal would impose reporting burdens on both purchasers of life insurance contracts and on life insurance companies that pay death benefits. The requirement for the insurance company to provide an "estimate" of a policy purchaser's basis in the contract being reported on may be difficult or problematic.

This provision was included in the administration's 2012 through 2016 revenue proposals.

Simplify minimum required distribution (MRD) rules

The administration's FY 2017 budget proposal would exempt an individual from the MRD requirements if the aggregate value of the individual's IRA and tax-favored retirement plan accumulations does not exceed \$100,000 on the measurement date. However, benefits under qualified benefit pension plans that have begun to be paid in life annuity form would be excluded. The MRD requirements would phase-in ratably for individuals with aggregate retirement benefits between \$100,000 and \$110,000.

The administration's FY 2017 proposal would harmonize the application of the MRD requirements for holders of designated Roth accounts and Roth IRAs by generally treating Roth IRAs in the same manner as all other tax-favored retirement accounts, i.e., requiring distributions to begin shortly after age 70½ years. Individuals would not be permitted to make additional contributions to Roth IRAs after they reach age 70½ years.

The provisions would be effective for individuals attaining age 70½ after December 31, 2016, and for taxpayers who die on or after December 31, 2016 before attaining age 70½ years.

The administration estimates that this provision would raise approximately \$498 million over the 10-year period.

Require non-spouse beneficiaries of deceased IRA owners and retirement plan participants to take inherited distributions over no more than five years

Under the administration's FY 2017 proposal, non-spouse beneficiaries of retirement plans and IRAs would generally be required to take distributions over no more than five years. Exceptions would be provided for eligible beneficiaries, including any beneficiary who, as of the date of the account holder's death, is: (1) disabled; (2) a chronically ill individual; (3) an individual who is not more than 10 years younger than the participant or IRA owner; or (4) a child who has not reached the age of majority. For these beneficiaries, distributions would be allowed over the life or life expectancy of the beneficiary beginning in the year following the year of the death of the participant or owner, except that in the case of a child, the account would need to be fully distributed no later than five years after the child reaches the age of majority.

According to the Green Book, any balance remaining after the death of a beneficiary (including an eligible beneficiary excepted from the five-year rule or a spouse beneficiary) would be required to be distributed by the end of the calendar year that includes the fifth anniversary of the beneficiary's death.

The proposal generally would apply to distributions with respect to plan participants or IRA owners who die after December 31, 2016. However, the requirement that any balance remaining after the death of a beneficiary be distributed by the end of the calendar year that includes the fifth anniversary of the beneficiary's death would apply to participants or IRA owners who die before January 1, 2016, if the beneficiary dies after December 31, 2016. The proposal would not apply in the case of a participant whose benefits are determined under a binding annuity contract in effect on the date of enactment.

The administration estimates that this provision would raise approximately \$6.264 billion over the 10-year period.

Limit the total accrual of tax-favored retirement benefits

Under the administration's FY 2017 proposal, a taxpayer who has accumulated amounts within the "tax-favored retirement system" (i.e., IRAs, section 401(a) plans, section 403(b) plans, and funded section 457(b) arrangements maintained by governmental entities) in excess of the amount necessary to provide the maximum annuity permitted for a tax-qualified defined benefit plan under current law (currently an annual benefit of \$210,000 payable in the form of a 100% joint and survivor benefit commencing at age 62 and continuing each year for the life of the participant and, if later, the life of the participant's spouse) would be prohibited from making additional contributions or receiving additional accruals under any of those arrangements. Currently, the maximum permitted accumulation for an individual age 62 years is approximately \$3.4 million.

According to the Green Book, the limitation would be determined as of the end of a calendar year and would apply to contributions or accruals for the following calendar year. Plan sponsors and IRA trustees would report each participant's account balance as of the end of the year as well as the amount of any contribution to that account for the plan year. For a taxpayer who is under age 62, the accumulated account balance would be converted to an annuity payable at age 62, in the form of a 100% joint and survivor benefit using the actuarial assumptions that apply to converting between annuities and lump sums under defined benefit plans. For a taxpayer who is older than age 62, the accumulated account balance would be converted to an annuity payable in the same form, when actuarial equivalence is determined by treating the individual as if he or she was still age 62; the maximum permitted accumulation would continue to be adjusted for cost of living increases. Plan sponsors of defined benefit plans would report the amount of the accrued benefit and the accrual for the year, payable in the same form.

The Green Book also explains that if a taxpayer reached the maximum permitted accumulation, no further contributions or accruals would be permitted, but the taxpayer's account balance could continue to grow with investment earnings and gains. If a taxpayer received a contribution or an accrual that would result in an accumulation in excess of the maximum permitted amount, the excess would be treated in a manner similar to the treatment of an excess deferral under current law.

The provision would be effective with respect to contributions and accruals for tax years beginning after December 31, 2016.

The administration estimates that this provision would raise almost \$30 billion over the 10-year period.

Taxation of Investments

Require that derivative contracts be marked to market with resulting gain or loss treated as ordinary

Under current law, the timing and character of gain and loss on derivative contracts depends on how the contracts are classified or traded. For example, gain or loss with respect to a forward contract is generally recognized when the contract is transferred or settled and is generally capital if the contract is with respect to property that is or would be a capital asset in the hands of the taxpayer. In contrast, certain exchange-traded futures contracts must be marked to market and the gain or loss is 60% long-term and 40% short-term capital gain or loss. Similarly, the tax treatment of certain options differs depending on whether they are entered into over-the-counter or traded on certain exchanges.

Similar to the administration's FY 2015 and 2016 proposals, the administration's FY 2017 proposal would generally require that a "derivative contract," as defined in the proposal, be marked to market annually (no later than the last business day of a taxpayer's tax year). Gain or loss would be recognized for tax purposes and would be treated as ordinary and as attributable to a trade or business of the taxpayer for purposes of section 172(d)(4). The source of income associated with a derivative would continue to be determined under current law. The proposal would also eliminate or amend a number of other provisions of the Code that address specific taxpayers and transactions, including section 475 (mark to market for securities dealers), section 1256 (mark to market and 60/40 capital treatment), section 1092 (tax straddles), section 1233 (short sales), section 1234 (gain or loss from an option), section 1234A (gains or losses from certain terminations), section 1258 (conversion transactions), section 1259 (constructive sale transactions), and section 1260 (constructive ownership transactions).

The proposal would define a "derivative contract" broadly to include any contract the value of which is determined, directly or indirectly, in whole or in part, by the value of actively traded property. An embedded derivative contract would also be subject to mark to market if the derivative itself would be. Thus, contingent debt or structured notes linked to actively traded property would be taxed as derivative contracts under the proposal.

In addition, actively traded stock that would not otherwise be subject to mark to market under the proposal would be required to be marked to market if it is part of a straddle transaction with a derivative contract (i.e., a derivative contract that substantially diminishes the risk of loss on the actively traded stock). Under such circumstances, pre-existing gain on the financial instrument would be recognized at the time of the mark, and loss would be recognized when such loss would have been recognized on the stock in

the absence of the straddle.

The proposal would also provide the Secretary with the authority to issue regulations matching the timing, source, and character of income, gain, deduction, and loss from a capital asset and a transaction that diminishes the risk of loss or opportunity for gain from that asset. The budget proposal provides the following example:

For example, in the case of stock issued by a U.S. corporation, the source of dividends on the stock would be U.S., while gain or loss on a sale of the stock is generally sourced based on the residence of the recipient. Thus, if a taxpayer were to hedge the stock with a notional principal contract (NPC), the Secretary would have the authority to write regulations that provide that dividend equivalent payments on the NPC are matched to the dividends on the stock for timing, source, and character, while gain or loss on the NPC could be matched to the gain or loss on the stock for timing, source, and character.

The proposal would not, however, apply mark-to-market treatment to a transaction that qualifies as a business hedging transaction. A business hedging transaction is a transaction that is entered into in the ordinary course of a taxpayer's trade or business primarily to manage risk of certain price changes (including changes related to interest rates, currency fluctuations, or creditworthiness) with respect to ordinary property or ordinary obligations, and that is identified as a hedging transaction before the close of the day on which it was acquired, originated, or entered into. The proposal provides that the identification requirement would be met if the transaction is identified as a business hedge for financial accounting purposes and it hedges price changes on ordinary property or obligation. The proposal would apply to derivative contracts entered into after December 31, 2016.

The administration estimates that this provision would raise over \$20 billion over the 10-year period.

KPMG observation

The administration's proposal imposes mark-to-market treatment on derivative contracts only when the value of the derivative contract is determined, directly or indirectly, in whole or in part, by the value of actively traded property. Although the administration's proposal would provide a framework for more uniform treatment of derivative contracts, taxpayers would still need to determine whether a particular financial instrument fits the definition of a derivative contract and thus be subject to mark-to-market treatment. Several details would need to be clarified, such as what constitutes actively traded property and what is an embedded derivative.

Require current inclusion in income of accrued market discount and limit the accrual amount for distressed debt

Market discount generally arises when a debt instrument is acquired in the secondary market for an amount less than its stated principal amount (or adjusted issue price, if it was issued with original issue discount (OID)). A holder of a debt instrument with market discount generally treats gain from a disposition of the instrument and principal payments under the instrument as ordinary income to the extent of the accrued market discount. Generally, market discount accrues ratably over the term of a debt instrument unless the holder elects to accrue on a constant yield basis instead. A holder may also elect to include market discount into income as it accrues.

Similar to the administration's FY 2016 proposal, the administration's FY 2017 proposal would require holders of debt instruments with market discount to include market discount currently in taxable ordinary income as it accrues. The proposal would require accrual of market discount on a constant yield basis. The proposal would also limit the accrual of market discount to the greater of: (1) the bond's yield to maturity plus 5%; or (2) the applicable federal rate for such bond plus 10%.

The proposal would apply to debt securities acquired after December 31, 2016.

The administration estimates that this provision would raise approximately \$396 million over the 10-year period.

KPMG observation

The proposal is based upon the premise that market discount that arises as a result of changes in interest rates or decreases in an issuer's creditworthiness subsequent to issuance is economically similar to OID, and like OID is to be accrued into income currently.

The proposal notes that current inclusion of market discount has historically been complicated by the fact that the amount of market discount on a debt instrument can vary from holder to holder since it is based upon each holder's acquisition price. The new information reporting rules would require brokers to include, on annual information returns, market discount accruals together with basis and other information for debt instruments, simplifying taxpayer compliance as well as the administrability of the proposal. Brokers are required to report cost-basis information, including market-discount accruals, for less complex debt instruments acquired after 2013 and more complex debt instruments acquired after 2015.

Expand the definition of substantial built-in loss for purposes of partnership loss transfers

Under current law, if there is a transfer of a partnership interest, the partnership is required to adjust the basis of its assets with respect to the transferee partner if the partnership at that time has a substantial built-in loss in its assets—i.e., if the partnership's adjusted basis in its assets exceeds the fair market value of its assets by more than \$250,000.

As was the case for the previous fiscal year's budget proposal, the FY 2017 proposal would extend the mandatory basis adjustment rules for transfers of partnership interests to require an adjustment with respect to the transferee partner, if such partner would be allowed a net loss in excess of \$250,000 if the partnership were to sell its assets for cash for fair market value in a fully taxable transaction immediately after the transfer. The adjustment would be required even if the partnership as a whole did not have a substantial built-in loss.

The proposal would apply to sales or exchanges after the date of enactment.

The administration estimates that this provision would raise approximately \$89 million over the 10-year period.

Extend partnership basis limitation rules to nondeductible expenditures

Under current law, a partner's distributive share of partnership losses for a tax year is allowed only to the extent of the partner's adjusted basis in its partnership interest at the end of the partnership tax year. Losses that are disallowed under this rule generally are carried forward and are allowed as deductions in future tax years to the extent the partner has sufficient basis at such time. The IRS issued a private letter ruling in 1984 concluding that this loss limitation rule does not apply to limit a partner's deduction for its share of the partnership's charitable contributions.

As was the case for the previous fiscal year's budget proposal, the administration's FY 2017 proposal would modify the statutory loss limitation rule to provide that a partner's distributive share of expenditures not deductible by the partnership (or chargeable to capital account) is allowed only to the extent of the partner's adjusted basis in the partnership interest at the end of the year.

A Joint Committee on Taxation (JCT) explanation of a substantially similar budget proposal for FY 2013 indicates that the current loss limitation rule is intended to limit a taxpayer's deductions to its investment in the partnership (taking into account its share of partnership debt). The JCT explanation suggests that the administration's proposal is intended to address the following concern:

Because of a technical flaw in the statute, which was written in 1954, it appears that the limitation does not apply, for example, to charitable contributions and foreign

taxes of the partnership, because those items are not deductible in computing partnership income. Because a partner's basis cannot be decreased below zero, a partner with no basis is allowed a deduction (or credit) for these items without having to make the corresponding reduction in the basis of his partnership interest that would otherwise be required.

The provision would apply to partnership tax years beginning on or after the date of enactment.

The administration estimates that this provision would raise approximately \$1.292 billion over the 10-year period.

Repeal technical terminations of partnerships

Under current law, a partnership can "technically terminate" under section 708(b)(1)(B) if, within a 12-month period, there is a sale or exchange of 50% or more of the total interest in both partnership capital and partnership profits. If a partnership technically terminates, certain events are deemed to take place to effectuate the tax fiction that the "old" partnership has terminated and a "new" partnership has begun.

Similar to the FY 2015 and 2016 proposals, the administration's FY 2017 proposal would repeal the technical termination rule of section 708(b)(1)(B), effective for transfers after December 31, 2016.

The administration estimates that this provision would raise approximately \$252 million over the 10-year period.

KPMG observation

Technical terminations can raise significant federal tax issues, many of which can be unfavorable from a taxpayer's perspective, but some of which can be favorable in particular fact situations. In addition, technical terminations raise compliance considerations. As a result, under current law, it can be important for partnerships to monitor sales and exchanges of their interests to determine if technical terminations may be triggered and to assess the consequences of such terminations based on their particular facts. Repealing the technical termination rules would reduce compliance burdens and would eliminate consequences—favorable and unfavorable—that can result in particular cases.

International Proposals

Restrict deductions for excessive interest of members of financial reporting groups

Under the FY 2017 proposal, the U.S. interest expense deduction of any member of a group that prepares consolidated financial statements in accordance with U.S. GAAP, IFRS, or other method authorized by the Secretary under regulations ("financial reporting group") would be limited to the member's interest income plus the member's proportionate share of the financial reporting group's net interest expense computed under U.S. income tax principles (based on the member's proportionate share of the group's earnings as reflected in the group's financial statements). U.S. subgroups would be treated as a single member of a financial reporting group for purposes of applying the proposal.

If a member fails to substantiate its proportionate share of the group's net interest expense, or a member so elects, the member's interest deduction would be limited to 10% of the member's adjusted taxable income (as defined under section 163(j)). Any disallowed interest would be carried forward indefinitely and any excess limitation for a tax year would be carried forward to the three subsequent tax years. A member of a financial reporting group that is subject to the proposal would be exempt from the application of section 163(j).

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 one or more U.S. income tax returns for a tax year. Entities that are exempt from this proposal would remain subject to section 163(j).

The proposal would be effective for tax years beginning after December 31, 2016.

The administration estimates that this provision would raise over \$70 billion over the 10-year period.

KPMG observation

The proposal is intended to address the use by multinational groups of debt to inappropriately shift profits to lower tax jurisdictions and, unlike section 163(j), considers the leverage of a multinational group's U.S. operations relative to its worldwide operations.

In addition, unlike other proposals (discussed below) that are focused primarily on the foreign activities of U.S. multinationals, this proposal appears principally intended to limit foreign-owned multinationals from disproportionately claiming interest expense against their U.S. income tax liability as compared to their tax liabilities elsewhere in the world.

Repeal delay in the implementation of worldwide interest allocation

The administration's FY 2017 budget proposal would accelerate the availability of the worldwide affiliated group election for allocating interest expense to tax years beginning after December 31, 2016. The Green Book states that accelerating the availability of the election would allow taxpayers to more accurately allocate and apportion interest expense for all purposes for which the allocation is relevant, including for implementing the new minimum tax proposal discussed below.

The administration estimates that this provision would lose over \$10 billion over the 10-year period.

Impose a 19% minimum tax on foreign income

The administration's FY 2017 proposal would supplement the existing subpart F regime with a new per-country minimum tax on foreign earnings of U.S. corporations and controlled foreign corporations (CFCs). The minimum tax would apply to a U.S. corporation that is a U.S. shareholder of a CFC or that has foreign earnings from a branch or from the performance of services outside the United States. Under the proposal, a foreign branch of a U.S. corporation would be treated like a CFC. The foreign earnings subject to the proposal would be subject to current U.S. taxation at a rate of 19% less 85% of the per-country foreign effective tax rate (the "residual minimum tax rate").

The foreign effective tax rate would be computed on an aggregate basis with respect to all foreign earnings and the associated foreign taxes assigned to a country for the 60-month period that ends on the last day of the domestic corporation's or CFC's tax year, as applicable. For this purpose, the foreign taxes taken into account are those taxes that generally would be eligible to be claimed as a foreign tax credit. The foreign earnings taken into account generally would be determined under U.S. tax principles but would include disregarded payments deductible elsewhere, such as interest or royalty payments among related CFCs, and would exclude dividends from related parties.

The country to which a CFC's foreign earnings and associated foreign taxes are assigned is based on the CFC's tax residence under foreign law, but the earnings and taxes of a particular CFC may be allocated to multiple countries if the earnings are subject to tax in multiple countries. If the same earnings of a CFC are subject to tax in multiple countries, the earnings and all of the foreign taxes associated with those earnings would be assigned to the highest-tax country.

The minimum tax for a particular country would be computed by multiplying the applicable residual minimum tax rate by the minimum tax base for that country. A U.S. corporation's minimum tax base for a country for a tax year would be the total amount of foreign earnings for the tax year assigned to that country, reduced by an allowance for corporate equity (ACE). The ACE provision would provide a risk-free return on equity invested in active

assets and is intended to exempt from the minimum tax a return on the actual activities undertaken in a foreign country.

For purposes of determining the foreign effective tax rate and the minimum tax base for a particular year, the proposal would include special rules to restrict the use of hybrid arrangements to shift earnings from a low-tax country to a high-tax country for U.S. tax purposes without triggering tax in the high-tax country. For example, no deduction would be recognized for a payment from a low-tax country to a high-tax country that would be treated as a dividend eligible for a participation exemption in the high-tax country. In addition, the earnings assigned to a low-tax country would be increased for a dividend payment from a high-tax country that is treated as deductible in the high-tax country.

The minimum tax would be imposed on current earnings regardless of whether they are repatriated to the United States. The subpart F regime generally would continue to require a U.S. shareholder of a CFC to currently include in gross income its pro rata share of the CFC's subpart F income, but the proposal would make several modifications to the existing subpart F rules as applied to U.S. corporate shareholders, including: (1) making the subpart F "high-tax" exception mandatory; (2) repealing rules regarding CFC investments in U.S. property; and (3) repealing rules regarding previously taxed earnings.

Additionally, a U.S. shareholder would not be subject to U.S. tax on gain on the sale of CFC stock to the extent the gain is attributable to the CFC's undistributed earnings. However, any gain in the stock that is attributable to unrealized gain in the CFC's assets would be subject to U.S. tax in the same manner as the future earnings from those assets (i.e., stock gain would be subject to the minimum tax or to the full U.S. rate to the extent the assets that would generate earnings are subject to the minimum tax or subpart F, respectively).

The proposal also would modify the foreign tax credit rules to prevent a U.S. corporate shareholder from offsetting its U.S. tax liability on low-taxed foreign income with foreign taxes attributable to earnings of a high-taxed CFC that were exempt from U.S. taxation.

Interest expense incurred by a U.S. corporation that is allocated and apportioned to foreign earnings on which the minimum tax is paid would be deductible at the residual minimum tax rate applicable to those earnings. No deduction would be permitted for interest expense allocated and apportioned to foreign earnings for which no U.S. income tax is paid.

The Secretary would be granted authority to issue regulations to carry out the purposes of the minimum tax, including regulations addressing the taxation of undistributed earnings when a U.S. corporation owns an interest in a foreign corporation that has a change in CFC

status, and regulations to prevent the avoidance of the minimum tax through outbound transfers of built-in-gain assets or CFC stock.

Lastly, the administration's FY 2017 budget would make permanent the temporary subpart F "look-through" exception in section 954(c)(6) for certain payments between related CFCs and subject any income qualifying under the look-through exception to the minimum 19% tax.

These proposals would be effective for tax years beginning after December 31, 2016.

The administration estimates that these proposals would raise over \$350 billion over the 10-year period.

KPMG observation

The administration's proposals to reform the U.S. international tax system effectively would divide foreign income into three categories: (1) foreign income that is subject to current taxation at the full U.S. tax rate under subpart F; (2) non-subpart F income that is subject to current U.S. taxation under the minimum tax provision, and thus may bear an effective tax rate as high as 19%; and (3) non-subpart F income that is exempt from U.S. taxation pursuant to the ACE allowance, which could possibly be completely tax-free on a worldwide basis. The per-country minimum tax computation and the high-tax exception would operate to assign discrete blocks of income into these three categories with little opportunity for taxpayers to average tax rates on their operations (or on subpart F vs. active income) in different countries to their benefit.

The minimum tax coupled with the ACE allowance is conceptually similar to the minimum tax proposal in former Ways and Means Chairman Camp's 2014 tax reform bill. Very generally, the Camp tax reform bill would have imposed a minimum tax of 15% on a CFC's foreign earnings by creating a new category of subpart F income (foreign base company intangible income or FBCII) for foreign earnings subject to an effective tax rate below 15%. Like the administration's ACE, the Camp tax reform bill excluded from the FBCII tax base a specified percentage (in the Camp tax reform bill, 10%) of the CFC's qualified business asset investment, which was defined by Camp as the aggregate adjusted basis of certain tangible depreciable property used in the CFC's trade or business. It is not clear how the ACE allowance would be determined under the administration's minimum tax provision.

The minimum tax proposal also includes several new concepts and raises a number of questions. For example, rather than allowing a foreign tax credit, the tentative U.S. minimum tax of 19% would be reduced by an average tax rate computed over a 60-month period. The administration did not provide its rationale for this rolling average approach, which generally would be similar in results to a five-year carryforward (and no carryback) for foreign tax credits in a per-country basket (subject to a 15% reduction).

The proposal also would amend the rules in section 1248 regarding the sale of CFC stock by certain U.S. shareholders. As discussed above, the proposal would currently tax gain in CFC stock that is attributable to unrealized gain in the CFC's assets to the extent the assets would give rise to subpart F income or income subject to the minimum tax. It is not clear, however, how this rule would apply if the U.S. shareholder acquired the CFC's stock without making a section 338(g) election, or if the gain is attributable to appreciation that occurred while the foreign corporation was not a CFC.

Impose a 14% one-time tax on previously untaxed foreign income

The administration's FY 2017 budget proposal would impose a one-time 14% tax on a CFC's accumulated earnings that were not previously subject to U.S. tax. A credit would be allowed for the amount of foreign taxes associated with such untaxed earnings multiplied by the ratio of the one-time tax rate to the maximum U.S. corporate rate for 2016. Any untaxed CFC earnings subject to this one-time tax could then be repatriated without any additional U.S. tax liability. The tax due under this proposal would be payable ratably over five years. This proposal would be effective on the date of enactment and would apply to earnings accumulated for tax years beginning no later than December 31, 2016.

The administration estimates that this provision would raise almost \$300 billion over the 10-year period.

KPMG observation

The computational details of this proposal have not been provided. For example, it is not clear whether or to what extent deficits in one CFC might offset earnings in another CFC for this purpose, or how the taxes paid by a CFC would be taken into account if the CFC has a deficit in earnings and profits.

Disallow the deduction for excess non-taxed reinsurance premiums paid to affiliates

The administration's FY 2017 proposal would: (1) deny an insurance company a deduction for reinsurance premiums for property and casualty risks paid to affiliated foreign reinsurance companies to the extent that the foreign reinsurer (or its parent company) is not subject to U.S. income tax with respect to the premiums received; and (2) exclude from the insurance company's income (in the same proportion that the premium deduction was denied) any ceding commissions received or reinsurance recovered with respect to reinsurance policies for which a premium deduction is wholly or partially denied.

A foreign corporation that receives a premium from an affiliate that would otherwise be denied a deduction under this proposal would be permitted to elect to treat the premium and the associated investment income as income effectively connected with the conduct of a trade or business in the United States, and attributable to a permanent establishment for tax treaty purposes.

For foreign tax credit purposes, reinsurance income that is treated as effectively connected under this rule would be treated as foreign source income and would be placed into a separate category within section 904.

The provision would be effective for policies issued in tax years beginning after December 31, 2016.

The administration estimates that this provision would raise approximately \$7.688 billion over the 10-year period.

KPMG observation

Similar proposals have been made in the last four budget proposals. The FY 2017 proposal, like the FY 2016 proposal, would limit the disallowance to property and casualty reinsurance premiums, making it consistent with former Ways and Means Chairman Camp's tax reform bill (February 2014).

This provision was included in the administration's FY 2012 through 2016 revenue proposals.

Tax gain from the sale of a partnership interest on look-through basis

The FY 2017 proposal would characterize gain or loss from the sale or exchange of a partnership interest as income effectively connected with the conduct of a trade or business in the United States (ECI) to the extent attributable to the transferor partner's distributive share of the partnership's unrealized gain or loss that is attributable to ECI property. The Secretary would be granted authority to specify the extent to which a distribution from the partnership is treated as a sale or exchange of an interest in the partnership and to coordinate the new provision with the nonrecognition provisions of the Code.

The proposal would also provide a collection mechanism in the form of gross basis withholding. The transferee of a partnership interest would be required to withhold 10% of the amount realized by the foreign partner on the sale or exchange of a partnership interest, unless the transferor certified that the transferor was not a nonresident alien individual or foreign corporation. Alternatively, if a transferor provided a certificate from the IRS that established that the transferor's federal income tax liability with respect to the transfer was less than 10% of the amount realized, the transferee would withhold such lesser amount. If the transferee failed to withhold the correct amount, the partnership would be liable for the amount of under-withholding, and would satisfy the withholding obligation by withholding on future distributions that otherwise would have gone to the transferee partner.

This proposal would be effective for sales or exchanges after December 31, 2016.

The administration estimates that this provision would raise approximately \$2.917 billion

over the 10-year period.

KPMG observation

The proposal would codify a longstanding IRS position set out in Rev. Rul. 91-32.

Limit the ability of domestic entities to expatriate

The proposal would broaden the definition of an inversion transaction by replacing the 80% test in section 7874 with a greater than 50% test, and it would eliminate the 60% test. The proposal would also provide that an inversion transaction would occur—regardless of the level of shareholder continuity—if:

- Immediately prior to the transaction, the fair market value of the domestic entity's stock is greater than the fair market value of the foreign acquiring corporation's stock;
- The foreign acquiring corporation's expanded affiliated group is primarily managed and controlled in the United States; and
- The foreign acquiring corporation's expanded affiliated group does not conduct substantial business activities in the country in which the foreign acquiring corporation is created or organized.

The proposal would also expand the scope of section 7874 to provide that an inversion transaction could occur if there is a direct or indirect acquisition of substantially all of the:

- Assets of a domestic corporation or domestic partnership,
- Trade or business assets of a domestic corporation or domestic partnership, or
- U.S. trade or business assets of a foreign partnership.

Finally, the proposal would provide the IRS with the authority to share tax return information with other federal agencies to facilitate the administration of an agency's anti-inversion rules. Other federal agencies that receive this information would be subject to the safeguarding and recordkeeping requirements of section 6103.

The proposals to limit a domestic entity's ability to expatriate would be effective for transactions completed after December 31, 2016. The proposal to allow the IRS to share tax return information with other federal agencies would be effective after December 31, 2016, without regard to when the inversion occurred.

The administration estimates that this provision would raise over \$13 billion over the 10-year period.

KPMG observation

The proposal is intended to limit the ability of domestic entities to expatriate. Under the proposal, the anti-inversion rules could apply if the continuing ownership of the domestic corporation's historical shareholders in the foreign acquiring corporation is more than 50%, and in such case the foreign acquiring corporation would be treated as a domestic corporation. Under the current anti-inversion rules in section 7874, the foreign acquiring corporation may be treated as a domestic corporation only if the continuing ownership is at least 80% (and in case the continuing ownership is at least 60% but less than 80%, other adverse but less severe tax consequences may apply). Thus, the proposed anti-inversion rules would be triggered at a lower threshold and with more severe consequences.

This proposed change is intended to address the fact that domestic entities have been combining with smaller foreign entities resulting in a continued ownership being less than 80% (although more than 60%). Treasury stated:

"The adverse tax consequences under current law of 60-percent inversion transactions have not deterred taxpayers from pursuing these transactions. There is no policy reason to respect an inverted structure when the owners of a domestic entity retain a controlling interest in the group, only minimal operational changes are expected, and there is potential for substantial erosion of the U.S. tax base."

Additionally, under the proposal, a foreign corporation's acquisition of a domestic entity could be treated as an inversion—even if there is no ownership continuity—if (1) immediately prior to the transaction, the domestic entity's fair market value is greater than the foreign acquiring corporation's fair market value, and (2) the foreign acquiring corporation's expanded affiliated group (A) is primarily managed and controlled in the United States, and (B) does not conduct substantial business activities in the foreign acquiring corporation's country of creation or organization. Treasury stated that, under these circumstances, the transaction would still be considered an inversion, even if the shareholders of the domestic entity do not maintain control of the resulting multinational group. Thus, it appears that an inversion could occur under this special rule when a foreign corporation purchases the domestic entity's ownership interests for cash and none of the domestic entity's former holders roll into the foreign corporation—i.e., all the former holders cash out of their investment or some of the former holders cash out and others choose to retain their direct investment in the domestic entity.

Section 7874 currently only applies to direct or indirect acquisitions of: (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 proposed changes to the scope of acquisitions covered by section 7874 are important in several respects. First, an inversion could occur when a foreign corporation acquires substantially all of a domestic corporation's trade or business assets, even though such assets do not

represent substantially all of the domestic corporation's total assets (e.g., if the domestic entity retains a significant amount of cash). Second, an inversion could occur when a foreign corporation acquires substantially all the assets of a domestic partnership regardless of whether the assets constitute a trade or business. Thus, the proposal would treat acquisitions of domestic corporations and domestic partnerships similarly, as opposed to the current section 7874 acquisition rules. Finally, an inversion could occur when a foreign corporation acquires substantially all of the U.S. trade or business assets of a foreign partnership—a clear departure from current law.

Finally, the proposal would permit the IRS to share tax return information with other federal agencies to promote any agency's anti-inversion rules. Currently, the IRS is restricted from sharing this information under section 6013.

Although not part of the inversion proposal, proposed modifications to section 958(b) and the definition of a CFC could have a significant impact on foreign-parented groups that include a U.S. corporation with its own foreign subsidiaries, including companies that have successfully "inverted" in the past.

Healthcare Proposals

Improve the excise tax on high cost employer-sponsored health coverage

The administration's FY 2017 budget proposal would modify section 4980I—the excise tax on high cost employer-sponsored health coverage enacted in 2010 as part of the Patient Protection and Affordable Care Act. The administration's FY 2017 budget proposal would raise the threshold at which health plans are subject to the tax in states with higher health-care costs. Specifically, the proposal would modify the threshold above which the tax applies to be equal to the greater of the current law threshold (\$10,200 for individual coverage and \$27,500 for family coverage, in 2018 dollars) or the average premium for a gold-level health plan in the employees' state of residency.

In addition, the proposal would provide that the cost of coverage under a health flexible spending arrangement (FSA) for similarly situated participating employees is equal to the sum of: (1) the average salary reduction amount elected by those employees for the year; and (2) the average employer contribution for such employees for the year. Furthermore, the proposal would authorize the Secretary of the Treasury to issue guidance identifying similarly situated employees.

Finally, the proposal would require the Government Accountability Office to conduct a study of the potential effects of the excise tax on firms with unusually sick employees, in consultation with Treasury and others. The provision would be effective for tax years

beginning after December 31, 2016. However, as under current law, no employer-sponsored health plans would be subject to the tax until 2020.

The administration estimates that this provision would lose approximately \$1.265 billion over the 10-year period.

KPMG observation

This is a new budget proposal designed to lessen the effects of the excise tax on high cost employer-sponsored health coverage (often referred to as the “Cadillac tax”) in geographic areas where health care costs are higher than the national average. Furthermore, the proposal appears to be intended to make it easier for employers offering FSAs to calculate the excise tax owed by providing a formula for measuring the cost of coverage under an FSA.

The effective date of the tax was postponed until 2020 through legislation enacted in December 2015, and legislative proposals have been introduced by members of Congress to repeal the excise tax entirely.

Expand and simplify the tax credit provided to qualified small employers for non-elective contributions to employee health insurance

Substantially similar to last year’s proposal, the administration’s FY 2017 proposal would expand the group of employers that are eligible for this credit to include employers with up to 50 full-time equivalent employees, and would begin the phase-out at 20 full-time equivalent employees. In addition, the coordination of the phase-outs between the number of employees and the average wage would be amended to provide for a more gradual combined phase-out. The proposal also would eliminate a requirement that the employer make a uniform contribution on behalf of each employee, and eliminate the limit imposed by the rating area average premium.

The provision would be effective for tax years beginning after December 31, 2015.

The administration estimates that this provision would lose approximately \$1 billion over the 10-year period.

Information Reporting

Deny deduction for punitive damages

The administration’s FY 2017 proposal would prohibit any deduction for punitive damages paid or incurred by the taxpayer, whether upon a judgment or in settlement of a claim. If the liability for punitive damages were covered by insurance, damages paid or incurred by the insurer would be included in the gross income of the insured person. The insurer would be required to report payments to the insured person and to the IRS.

The provision would apply to damages paid or incurred after December 31, 2016.

The administration estimates that this provision would raise approximately \$741 million over the 10-year period.

Require information reporting for private separate accounts of life insurance companies

The administration's FY 2017 proposal would require life insurance companies to report to the IRS—for each contract with cash value that is partially or wholly invested in a private separate account for any portion of the tax year and represents at least 10% of the value of the account—(1) the policyholder's taxpayer identification number; (2) the policy number; (3) the amount of accumulated untaxed income; (4) the total contract account value; and (5) the portion of that value that was invested in one or more private separate accounts.

For this purpose, a private separate account would be defined as any account with respect to which a related group of persons owns policies with cash values, in the aggregate, of at least 10% of the value of the separate account. Whether a related group of persons owns policies with cash values at 10% or greater of the account value would be determined quarterly, based on information reasonably within the contract issuer's possession.

The provision would be effective for private separate accounts maintained on or after December 31, 2016. This provision was included in the administration's FY 2012 through FY 2016 revenue proposals.

The administration estimates that this provision would raise approximately \$9 million over the 10-year period.

Provide for reciprocal reporting of information in connection with the implementation of the Foreign Account Tax Compliance Act

Under FATCA, foreign financial institutions are required to report account balances, as well as amounts such as dividends, interest, and gross proceeds paid or credited to a U.S. account without regard to the source of such payments. To implement FATCA, the United States has established a broad network of information exchange relationships with other jurisdictions based on established international standards. The success of those information exchange relationships depends on cooperation and reciprocity. Requiring U.S. financial institutions to report to the IRS the comprehensive information required under FATCA with respect to accounts held by certain foreign persons, or by certain passive entities with substantial foreign owners, would facilitate the intergovernmental cooperation contemplated by the intergovernmental agreements by enabling the IRS to provide equivalent levels of information to cooperative foreign governments in

appropriate circumstances to support their efforts to address tax evasion by their residents.

The administration's FY 2017 proposal would require certain financial institutions to report the account balance (including, in the case of a cash value insurance contract or annuity contract, the cash value or surrender value) for all financial accounts maintained at a U.S. office and held by foreign persons. The proposal also would expand the current reporting required with respect to U.S. source income paid to accounts held by foreign persons to include similar non-U.S. source payments. In addition, the Secretary would be granted authority to issue Treasury regulations to require financial institutions to report the gross proceeds from the sale or redemption of property held in, or with respect to, a financial account, information with respect to financial accounts held by certain passive entities with substantial foreign owners, and such other information that the Secretary or his delegate determines is necessary to carry out the purposes of the proposal. Finally, the proposal would require financial institutions that are required by FATCA or this proposal to report to the IRS information with respect to financial accounts to furnish a copy of the information to the account holders.

The proposal would be effective for returns required to be filed after December 31, 2017.

The administration estimates that this provision would have no revenue effect over the 10-year period.

KPMG observation

This proposal could result in a significant increase in costs and burdens on U.S. businesses with respect to the proposed expansion of reporting. This provision was included in the administration's FY 2015 and 2016 revenue proposals.

Accelerate information return filing due dates

Many information returns, including Forms 1099, 1098, and 1096, are required to be filed with payees by January 31 and with the IRS by February 28 of the year following the year for which the information is being reported. Third-party information is used by taxpayers to assist them in preparing their income tax returns and used by the IRS to determine a taxpayer's compliance with federal tax obligations.

The administration's 2017 budget proposal would accelerate the due date for filing information returns and eliminate the extended due date for electronically filed returns. Under the proposal, information returns would be required to be filed with the IRS (or SSA, in the case of Form W-2) by January 31, except that Form 1099-B would be required to be filed with the IRS by February 15. The due dates for the payee statements would remain the same.

The proposal would be effective for returns required to be filed after December 31, 2016. This provision was included in the administration's FY 2016 budget proposals.

The administration estimates that this provision would raise approximately \$109 million over the 10-year period.

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