Tax Provisions in Biden Administration's FY 2022 Budget Proposals

Insurance

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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 specific industries and topics in separate reports. This booklet highlights revenue proposals of likely interest to the insurance industry. Other booklets will address proposals relating to other topics.

This booklet reflects developments and analysis as of June 17, 2021. For information regarding subsequent developments, see ***TaxNewsFlash-Legislative Updates***.

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, 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 reflects the Biden Administration's current tax priorities—signaling to Congress the administration's view that these ideas are of greatest importance to President Biden's 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.

KPMG observation

The Biden Administration has set forth an ambitious long-term infrastructure and social support program. Congress might act on all or part of that program, or 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 possible legislation.

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Additional proposals could be added to potential legislation as well. Indeed, it would not be surprising if significant modifications were made to the Biden Administration's tax proposals if and when they are considered in Congress.

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Corporate

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.

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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.

The TCJA added many new provisions to Subchapter L that increased the amount of taxable income for insurance companies compared to the pre-TCJA Code. Because the corporate tax rate was reduced from 35% to 21% by the TCJA, insurance companies generally did not see significant change to their tax liabilities from pre-TCJA tax years to post-TCJA tax years. If the corporate tax rate were significantly increased to 28%, insurance companies may see increased tax liabilities relative to what they owed in pre-TCJA tax years.

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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 discussions of the **revise the global minimum tax regime** in KPMG's 117-page report on the Green Book and the **replace BEAT with SHIELD rule** proposal 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

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to prepay their regular tax.

The proposal lacks key implementation details. As one 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. As another example, if a large foreign multinational enterprise has a relatively small taxable presence in the U.S. through a domestic subsidiary corporation, it may be reasonable to assume that the full weight of the proposed tax on worldwide income would not be levied against the U.S. subsidiary, and that some set of geographically-based allocation rules would be added. 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., R&D, 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

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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. It also remains to be seen exactly how this new AMT might impact some large insurance companies. Because of some of the insurance-specific tax changes made by the TCJA, a 15% minimum tax, if applicable, could increase insurance company tax liabilities to amounts greater than what was incurred for pre-TCJA tax years.

An alternative minimum tax would likely make tax credits more valuable to affected insurance companies. The Biden Administration's Green Book includes several new tax credit proposals. These mainly deal with creating clean energy. KPMG tax professionals expect that insurance companies might look for ways to increase available tax credits

International

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 Base Erosion and Anti Abuse Tax ("BEAT") and replace it with the "Stopping Harmful Inversions and Ending Low-Tax Developments "(SHIELD") regime. The stated intent of the proposal is to address - more effectively than BEAT - concerns regarding erosion of the US corporate tax base, while simultaneously providing a strong incentive for other jurisdictions to adopt the income inclusion rule (IIR) that is currently being developed at the OECD as part of Pillar Two or alternatively for low-tax jurisdictions to implement or strengthen their own corporate tax regimes.

Mechanics of SHIELD—In general

SHIELD would disallow deductions of domestic corporations or branches, and would apply to any

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financial reporting group that (1) includes at least one domestic corporation, domestic partnership, or foreign entity with a US 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. Generally Accepted Accounting Principles (GAAP), International Financial Reporting Standards (IFRS), or another method authorized by regulations.

Deductions would be disallowed 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 any member of the financial reporting group.

KPMG observation

As discussed in further detail below, SHIELD does not build on the BEAT infrastructure in any significant way. While the $500 million revenue threshold for applying SHIELD may appear similar to the BEAT's gross receipts threshold at first glance, the proposed scope of SHIELD is drastically broader than BEAT. BEAT applies to corporate taxpayers with average aggregate annual gross receipts of at least $500 million (determined under U.S. tax principles, over a three-year period, counting only gross receipts of the group that are subject to U.S. federal income tax), and a "base erosion percentage" in excess of 3% (2% for affiliated groups containing certain financial institutions). SHIELD, by contrast, would apply to any financial reporting group with a minimum degree of U.S. presence and greater than $500 million in global consolidated revenue for financial statement purposes. The elimination of the base erosion percentage threshold and the focus on worldwide revenue rather than U.S. revenue would dramatically broaden the scope of taxpayers potentially covered by SHIELD relative to the BEAT.

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 $500 million 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, but has not indicated a willingness to similarly align the revenue threshold. 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 this 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. The lower U.S. threshold might cause some countries with significant U.S. investment to consider lowering the threshold for their own IIR regimes.

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%).

A financial reporting group member's SHIELD ETR would be determined by taking into account income

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earned (aggregating related and unrelated party income) and taxes paid or accrued with respect to the income earned in that 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

It's unclear whether taxes "paid or accrued" would rely on financial accounting concepts (and include deferred tax liabilities and taxes accrued for uncertain tax positions) or tax accounting concepts such as those found in section 901 or if Treasury would institute a different mechanism to address permanent and temporary differences between income tax and financial accounting bases or indeed if all such differences would be accounted for under SHIELD.

It's suggested, but somewhat unclear, that taxes "paid or accrued with respect to income earned in that jurisdiction" would include a broader tax base than just that jurisdiction's corporate income tax. With the stated goal of inducing jurisdictions to implement IIR's, the language may likely be read to include withholding taxes, a parent jurisdiction's CFC taxes, or its taxes imposed under an IIR, etc.

Disallowed deductions—Determination

The determination of disallowed deductions is a two-step process: (i) determine the amount of payments made (or deemed made) to a low-taxed member of the financial reporting group, and (ii) deny deductions in an amount equal to the amount of payments made, or deemed to be made, to low-taxed entities, as determined in (i).

For purposes of step (i), 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"). For purposes of this step, "payments" (whether under the Direct Payments Rule or Indirect Payments Rule) are not limited to deductible payments, and instead include all gross payments, including, for example, payments included in COGS.

The deductions denied in step (ii) are not necessarily the payments identified in step (i). If the payment identified in the first step is otherwise deductible, the deduction for the payment would be disallowed in its entirety under SHIELD. If, however, the relevant payment is not otherwise deductible, then other deductions—including deductions for payments to "high tax" members and payments to unrelated parties—would be disallowed up to the amount of the payment.

KPMG observation

The SHIELD's proposed full deduction disallowance under the Direct Payments Rule 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.

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KPMG example

Assume that a domestic corporation makes a $100x deductible payment directly to a low-taxed member. The payee jurisdiction's income is $10x and the taxes paid and accrued are $2.09x, resulting in a SHIELD ETR of 20.9%. Assuming that SHIELD's designated minimum tax rate is 21%, SHIELD would disallow the entire $100x deduction, rather than a proportionate amount based upon the difference between the low-taxed member's SHIELD ETR (20.9%) and the designated minimum tax rate (21%).

KPMG observation

SHIELD's Indirect Payments Rule is a notable expansion of the indirect payment rule in the OECD's UTPR, because unlike the UTPR, SHIELD's Indirect Payments Rule would apply even if the low-taxed members of the financial reporting group do not actually receive any payments from any member of the financial reporting group. Moreover, while the Indirect Payments Rule would treat only a portion of a payment to a high-tax group member as subject to SHIELD, the deduction for that portion of the payment is denied in full.

KPMG example

Assume that a financial reporting group has 1,000x of total profit. The group has a single low-tax member (FCo) which has 100x of profit. Domestic Corporation (DC) does not make any direct payments to FCo, but DC does make a 10x payment to a high-tax group member (GCo), which is DC's only payment to a member of the financial reporting group. Under the Indirect Payments Rule, 10% (100x of low-tax profits / 1,000x of total profits) of the 10x payment from DC to GCo would be deemed to have been made from DC to FCo, and thus 1x of deductions (related or unrelated) would be disallowed.

Exceptions and exemptions

The proposal does not indicate that any exceptions would apply based on the type of payment. 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 nonprofit entities. Treasury also would be expected to write rules to take into account payments by partnerships.

KPMG observation

A footnote in the proposal provides that SHIELD would also take into account, in the same manner as deductible payments, reductions in gross amounts of premiums and other consideration on certain insurance, reinsurance, and annuity contracts. Thus, similar to BEAT, reductions in gross income due to premiums paid for reinsurance would be within the scope of SHIELD for purposes of both 1) determining the amount of gross payments to low-taxed members and 2) disallowing deductible payments. In a departure from previous guidance issued by Treasury related to BEAT, "insurance policy claims and benefits accrued and losses paid" would also be within scope.

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Given (i) the accounting principles generally applicable to insurance companies for both tax and financial reporting purposes, (ii) the large volume and amount of gross payments involved in both the underwriting and claims cycles, and (iii) the apparent lack of a ceiling or top-up mechanism to determining disallowed deductible payments, the impact to an insurance organization that includes both a US member and a low-taxed member could be significant.

Many organizations—insurance and non-insurance—reacted to BEAT by reducing or eliminating payments made to foreign related parties, in order to fall below the 3% Base Erosion Percentage threshold and thereby not be subject to BEAT. For example, quota-shares to foreign related parties were reduced or eliminated by some insurance companies. It would appear that similar actions would not fully eliminate a SHIELD liability, because under the SHIELD Indirect Payments Rule, the presence of any low-taxed group member would result in disallowed deductions if a US member makes payments to any member of the financial reporting group.

Taxation of high-income taxpayers

Increase the top marginal income tax rate for high earners

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% rate 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.

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

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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 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.
>
> 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.

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 that may be enacted, it is interesting to note the potential consequences if the proposal were enacted with 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.

KPMG observation

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 the highest of any of the 38 OECD member countries. The combination of a higher

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marginal tax rate and the increased tax on capital gains might be expected to change the investment portfolios of high-income individuals and make life insurance and annuities more tax effective. KPMG tax professionals expect that life insurance companies might want to develop products that allow policyholders to enjoy the deferred taxation allowed on inside build-up, as well as allowing the appreciated investments that support life insurance contracts to pass to beneficiaries as tax-exempt death benefits.

Improve compliance

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

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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.

As financial institutions, insurance companies might see additional scrutiny on financial account reporting.

Improve tax administration

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

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

The proposal does not include an effective date.

KPMG observation

The IRS on September 9, 2020, posted on its website final regulations (T.D. 9911). With the TD, it was determined that electronic filers must file their annual statement or a portion thereof in accordance with the applicable rules in the forms or instructions. At that time, the IRS and Treasury Department anticipated that once the IRS has the capacity to accept the electronic filing of annual statements, the tax return forms and instructions will require electronic filing of all or portions of the annual statement. To this date, the capability of the IRS to accept electronic filings has not been established.

KPMG contacts

Insurance	Sheryl Flum	sflum@kpmg.com	+1 202-533-3394
	Frederick Campbell-Mohn	fcampbellmohn@kpmg.com	+1 212-954-8316
	William Santini	wsantini@kpmg.com	+1 203-406-8551

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Contact us

For questions on legislative matters, contact a professional in the Federal Legislative and Regulatory Services group of KPMG's Washington National Tax:

John Gimigliano
T: +1 (202) 533-4022
E: jgimigliano@kpmg.com

Carol Kulish
T: +1 (202) 533-5829
E: ckulish@kpmg.com

Tom Stout
T: +1 (202) 533-4148
E: tstoutjr@kpmg.com

Jennifer Acuña
T: +1 (202) 533-7064
E: jenniferacuna@kpmg.com

Jennifer Bonar Gray
T: +1 (202) 533-3489
E: jennifergray@kpmg.com

www.kpmg.com

kpmg.com/socialmedia

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