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Tax Provisions in Biden Administration's FY 2022 Budget Proposals

Inbound

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Introduction

KPMG LLP on May 31, 2021, released a 117-page **report** [PDF 1.4 MB] containing analysis and observations of tax proposals in Biden Administration's FY 2022 budget. For ease of reference, KPMG has compiled summaries and observations relating to certain industries and topics in separate booklets. This booklet highlights select proposals that are most relevant to foreign parented U.S. companies. Other booklets address proposals relating to other topics.

This booklet reflects developments and analysis as of June 27, 2021. For information regarding subsequent developments, see ***TaxNewsFlash-Legislative Updates***.

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This booklet is organized as follows:

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Background

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

During the presidential race of 2020, President Joe Biden actively campaigned on an ambitious tax plan. His campaign tax plan was in some ways centered on the idea that the major tax legislation enacted in

2017 typically called the Tax Cuts and Jobs Act ("TCJA"), championed by the Trump Administration, had cut taxes too much and in the wrong ways. Read **KPMG's detailed analysis of the TCJA** [PDF 6.4 MB]

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

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

The FY 2022 Green Book represents then, the Biden Administration's current tax priorities—signaling to Congress the administration's view that these ideas are of greatest importance to his current legislative agenda. With Congress gearing up to do 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.

Finally, 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.

The Biden Administration's tax recommendations are, of course, only recommendations. Congress can accept, reject, or modify them as part of the legislative process, as well as add other proposals. It can also choose to offset all or only a part of any spending programs it approves.

With that in mind, what follows in this document is KPMG's more detailed explanation of select Biden Administration's tax proposals that are most relevant to foreign parented U.S. companies.

Certain corporate and international tax proposals that are particularly relevant for U.S. inbound foreign parented multinational groups.[1]

Corporate and international revenue-raising proposals include:

- Increasing the statutory corporate rate to 28%
- Replacing the "base erosion anti-abuse tax" (BEAT) with a new "stopping harmful inversions and ending low-tax developments" (SHIELD) regime that would deny U.S. tax deductions for payments to foreign related parties subject to a "low effective tax rate" (ETR)
- Restricting the deduction of interest by a financial reporting group attributable to disproportionate
- U.S. borrowing
- Limiting the ability of domestic corporations to expatriate by tightening the anti-inversion rules

[1] Various other Green Book proposals may be relevant certain U.S. inbounds and foreign-parented U.S. companies with foreign subsidiaries, including the proposed changes to GILTI and FTCs, elimination of FDII, and expansion of section 265 to disallow deductions attributable to income exempt from tax. Please refer to our full analysis, **KPMG report: Analysis and observations of tax proposals in Biden Administration's FY 2022 budget**

Effective dates

Congress will ultimately determine the effective dates of any tax legislation, as well as any transition and grandfather rules it deems appropriate. In most cases, the Green Book proposes that the tax changes be effective January 1, 2022 (which is how budget recommendations are ordinarily submitted). There are exceptions, however, particularly with respect to those provisions that may impact inbound investments.

Notably, the proposal to replace the BEAT with the SHIELD would generally apply to tax years beginning on or after January 1, 2023. This date—one year later from most of the other corporate proposals—could be intended to provide flexibility related to the ongoing BEPS 2.0 negotiations at the OECD.

In addition, the proposed anti-inversion provisions would apply to transactions completed after the date of enactment.

Corporate (in general)

Raise the corporate income tax rate to 28%

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

KPMG observation

The administration states that this proposal, estimated by Treasury to raise more than $850 billion over 10 years, is an administratively simple way to raise revenue to pay for infrastructure proposals, increase progressivity, and help reduce income inequality. 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.

Stopping harmful inversions and ending low-tax developments

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

The administration's proposal would repeal the BEAT imposed by section 59A and replace it with the SHIELD rule for tax years beginning after December 31, 2022. The stated intent of the proposal is to

address concerns regarding erosion of the U.S. corporate tax base more effectively than BEAT, while simultaneously providing a strong incentive for other jurisdictions to adopt the income inclusion rule (IIR) that is currently being developed at the OECD as part of its work on Pillar Two.

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

Taxpayers subject to SHIELD

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

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

KPMG observation

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. It is worth noting as well that the revenue threshold under SHIELD does not appear to allow for smoothing over multiple years, consistent with the Pillar Two approach. Accordingly, it may be the case that a taxpayer may trip into and out of SHIELD if a year is atypical or if global revenue fluctuates from year-to-year given the nature of its business.

KPMG observation

The OECD's Pillar Two is proposed to apply to groups that have greater than €750 million (or almost $1 billion) of global annual revenue. The choice of a $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.

Conditions for applying SHIELD

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

"Low-taxed" members

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

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

KPMG observation

The proposal to use the proposed 21% GILTI rate, in the absence of an agreed upon Pillar Two rate, appears to be intended to create an incentive for other jurisdictions to reach agreement on Pillar Two.

The Pillar Two rate is anticipated to be lower than 21%. Treasury recently announced that it proposed to the OECD Steering Group of the Inclusive Framework on BEPS that the Pillar Two rate should be at least 15%, although some countries, including Ireland and Hungary, have already publicly expressed opposition to a 15% minimum rate. Legislation enacting SHIELD thus would seem to require some mechanism to provide for a lower rate once agreement on Pillar Two is reached. This could be challenging without having more details about the mechanics of a future Pillar Two consensus. At the very least, this aspect of the proposal offers a political commitment that the administration will seek to incorporate this alignment with Pillar Two into SHIELD legislation either at the outset or by future amendment.

A financial reporting group member's SHIELD ETR would be determined by taking into account income earned (aggregating related and unrelated party income) and taxes paid or accrued with respect to the income earned in 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

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

KPMG observation

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

KPMG observation

The SHIELD ETR is computed by dividing "taxes paid or accrued" by "income earned," determined based on financial statements. Taxes paid or accrued" likely refers to section 901-type taxes, which would include not only local country net basis taxes, but presumably also source-jurisdiction withholding taxes imposed on the income and taxes paid by a parent under a CFC rule. Notably, Pillar Two allows for a slightly wider range of creditable taxes than section 901. Note also that the grant of regulatory authority in the proposal does not indicate whether the SHIELD ETR calculation is intended to align with Pillar Two on the treatment of permanent differences, temporary differences, or NOLs.

KPMG observation

Under Pillar Two, both for purposes of the IIR and for purposes of the undertaxed payments rule (UTPR), which operates as a backstop to the IIR, the ETR calculation includes a "formulaic substance-based carve-out" for payroll and tangible assets within the relevant jurisdiction. Not surprisingly, SHIELD would not include such a carve-out, consistent with the existing BEAT design as well as the administration's proposal to eliminate the carve-out for QBAI in GILTI.

Payments by a domestic corporation or branch

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

More specifically, determining the deductions that would be denied under SHIELD is a two-step process. The first step is to determine the amount of payments made (or deemed made) to a low-taxed member of the financial reporting group. For that purpose, a payment made directly to a low-taxed member is subject to SHIELD in its entirety (the "Direct Payments Rule"). In the case of a payment to a member that is not low-taxed, a portion of the payment is deemed to be made to the low-taxed member(s), based

on the ratio of the financial reporting group's low-taxed profits over the group's total profits, determined using the group's consolidated financial accounts (the "Indirect Payments Rule"). Importantly, for purposes of this first step (under either the Direct Payments Rule or the Indirect Payments Rule), "payments" are not limited to deductible payments, and instead include all gross payments, including payments included in COGS.

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

KPMG observation

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

KPMG observation

SHIELD's Indirect Payments Rule is a notable expansion of the indirect payment rule in the OECD's UTPR. Like the OECD's UTPR, SHIELD would not require taxpayers to trace through chains of payments, the methodology applied under the imported mismatch rules for hybrids in OECD BEPS Action 2 and the section 267A regulations. Unlike the UTPR, however, 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. For example, 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. Assume, for example, 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.

This result seems intended to address structures where the jurisdiction of the ultimate parent entity (UPE) is low-taxed and the UPE does not receive any related-party payments. The OECD's UTPR, as currently proposed, would not apply to those structures, while SHIELD would.

KPMG observation

Unlike BEAT, SHIELD would explicitly apply to non-deductible payments (like COGS) in addition to deductible payments. Rather than directly disallowing a reduction to gross income with respect to a COGS payment, under SHIELD a domestic corporation or branch would disallow other deductions in an amount up to the amount of the payment. Notably, those "other" deductions include deductions on payments to "high tax" members as well as payments to unrelated parties. Although not explicitly addressed, it seems likely based on the treatment of COGS that any payment that is capitalized into basis would be considered a "nondeductible payment" for this purpose that would trigger the requirement to disallow other deductions.

For example, assume that Domestic Corporation (DC) makes a $100x payment for finished inventory (COGS) to a low-tax group member. Assume further that DC does not make any deductible payments to related parties, but does make a $100x deductible payment to an unrelated party (3rd Party). In this case, DC's $100x deduction attributable to its payment to 3rd Party would be entirely disallowed by SHIELD.

The decision not to reduce COGS or adjust cost recovery directly, and instead require a taxpayer to disallow other deductions, may have been motivated by international trade agreement and tax treaty compliance concerns. By contrast, the OECD's UTPR seems to permit application directly to payments for COGS.

This requirement to disallow unrelated deductions in lieu of a reduction to COGS (or, presumably, other cost recovery for basis) might lead to distortive and problematic results. For example, disallowing unrelated current deductions can produce timing distortions that effectively accelerate a U.S. taxpayer's income to the extent that the cost recovery through COGS or other basis recovery will occur in a future tax period. In addition, this rule could also cause foreign tax credit limitation distortions. For instance, in the example above, assume that the COGS payment relates to property that will generate foreign source income when sold, while the deductible payment to 3rd Party relates to a U.S. source income generating activity. It would appear that the application of SHIELD here, by disallowing a deduction that is unrelated to the offending payment, would potentially change the taxpayer's foreign tax credit (FTC) limitation (i.e. the taxpayer would have less foreign source income than if the COGS basis were instead reduced). More generally, if a taxpayer makes deductible payments to both related and unrelated parties, a coordination rule would presumably be required to determine which deductions are treated as denied and for what purposes.

Special payment exemption categories

KPMG observation

Applying the Direct Payments Rule and Indirect Payments Rule concurrently appears to create a potential double counting issue. For example, assume that a domestic corporation (DCo) has two other members in its financial reporting group – FCo (low-taxed) and GCo (high-taxed). DCo makes a $100x payment directly to FCo and is disallowed the full deduction associated with that payment. In addition, DCo makes a $100x payment to GCo. Assume further that FCo's profits are $50x and the group's total profits are $500x. Is 10% of DCo's payment to GCo treated as made to FCo, and 10% of the deduction denied, even though DCo has already been denied a deduction of more than

FCo's income? It seems unlikely that such a result is intended, but additional rules would be needed to prevent it.

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

KPMG observation

While BEAT applies a broad aggregate approach to partnerships, it is not clear how partnerships would be treated under SHIELD, nor whether the treatment of a partnership under foreign law would be relevant to its treatment under SHIELD.

Delayed effective date

Under the proposal, SHIELD would not apply until tax years beginning on or after January 1, 2023.

KPMG observation

This proposed effective date would delay implementation of SHIELD until tax years beginning in 2023 and later. The proposal appears to contemplate that BEAT would continue to operate in its current form in the intervening years, because no changes are proposed to BEAT. Notably, if BEAT continues to apply, it may get caught-up in the ongoing negotiations at the OECD on Pillar One regarding the standstill and roll-back of "relevant unilateral measures." Other countries likely view BEAT as a relevant unilateral measure, and, therefore, would require that it be withdrawn by the United States should an agreement be reached on Pillar One. SHIELD is notably the only corporate tax reform proposal in the administration's FY22 budget that adopts an effective date beyond December 31, 2021. While the administration does not explain the delayed effective date for SHIELD, presumably it is intended to provide OECD Inclusive Framework members with time to agree to and implement a Pillar Two minimum tax. Additionally, given the complexity and the potentially harsh consequences of running afoul of SHIELD, taxpayers and foreign jurisdictions would need time to digest and conform, and, perhaps equally importantly, Treasury and the IRS would need sufficient time to draft the necessary guidance.

New interest expense limitation rule

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

Very generally, this proposal would limit a taxpayer's deductible interest expense if the taxpayer is a member of a multinational group and is considered to have disproportionate net interest expense as compared to the rest of the group. The proposal would apply only to multinational groups that prepare consolidated financial statements in accordance with GAAP, IFRS, or another method identified under

regulations ("financial reporting group"), and would determine the amount of disproportionate interest expense entirely by reference to financial statement metrics, as set forth below.

KPMG observation

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

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

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

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

KPMG observation

The proposal largely follows the prior Obama Green Book proposals. It also is consistent with the OECD BEPS, Action 4 Report (Limiting Base Erosion Involving Interest Deductions and Other Financial Payments), which recommended a profit-based "group ratio" approach that would allow a member of a financial reporting group interest deductions up to the group's net third-party interest/EBITDA ratio. Unlike the OECD BEPS, Action 4 approach, however, the proposal would restrict interest expense deductions to the lesser of the amount permitted under this profit-based group ratio approach and the amount otherwise permitted under section 163(j) U.S. earnings stripping rules.

KPMG observation

For tax years beginning on or after January 1, 2022, in applying section 163(j), adjusted taxable

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

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

KPMG observation

Assume a foreign parent files a consolidated financial statement with a wholly owned U.S. subsidiary, and the parent and subsidiary earn equal amounts of EBITDA. The foreign parent's only borrowing is $100 at 5%, which is on-lent to the U.S subsidiary at 6%. Absent the proposal, the U.S. subsidiary would deduct the full $6 of interest expense for U.S. tax purposes.

The U.S. subsidiary's net interest expense for financial reporting purposes is $6, and the group's net interest expense reported on the consolidated financial statements is $5 (the $6 of intercompany interest income and expense are eliminated in consolidation). The U.S. subsidiary's proportionate share of the group's $5 of net interest expense is 50% or $2.50. In this case, the US subsidiary's excess net interest expense would be $3.50 ($6-$2.50), and the U.S. subsidiary's current deduction for interest expense would be disallowed based on the amount of its net interest expense for U.S. tax purposes ($6) multiplied by the ratio of its excess net interest expense ($3.50) divided by its net interest expense for financial reporting purposes ($6). Thus, in this example, $3.50, calculated as $6*($3.50/$6), would be disallowed. The disallowed interest would be carried forward as described below.

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

KPMG observation

Although the proposal expressly contemplates that "excess limitation would be converted into a proportionate amount of excess limitation for U.S. tax purposes and carried forward as set forth below," the proposal then fails to take the topic back up and explicitly address the duration of any

such carry forward. By comparison, the Obama-era proposal provided for an indefinite carry forward of disallowed net interest expense and a three-year carryforward for excess limitation. The language describing the three-year carryforward was struck from the description of the new proposal without providing an alternative carryforward period. Query whether the intention was to provide for an indefinite carryforward, to eliminate the carryforward entirely, or something else.

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

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

KPMG observation

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

Anti-inversion rules

Limit the ability of domestic entities to expatriate (i.e., "anti-inversion rules")

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

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

- After the acquisition, at least 60% of the stock in the foreign acquiring corporation (by vote or value) is held by the former shareholders or the former partners of the domestic entity by reason of holding

their stock or interests in the domestic entity (such percentage, the "ownership percentage"); and

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

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

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

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

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

KPMG observation

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

Changes to the definition of domestic entity acquisition: The proposal would expand the scope of a domestic entity acquisition. As noted above, a domestic entity acquisition occurs under current law when

a foreign acquiring corporation directly or indirectly acquires (1) substantially all the properties directly or indirectly held by a domestic corporation, or (2) substantially all the properties constituting a trade or business of a domestic partnership. The proposal would also include as a domestic entity acquisition the direct or indirect acquisition by a foreign acquiring corporation of substantially all of:

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

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

KPMG observation

The change to the definition of domestic entity acquisition would create parity in the way section 7874 applies to acquisitions of the assets of domestic corporations and domestic partnerships. Specifically, the proposal would treat as a domestic entity acquisition a foreign acquiring corporation's direct or indirect acquisition of substantially all the assets of, or substantially all the assets constituting a trade or business of, a domestic corporation or a domestic partnership.

Therefore, under the proposal, a foreign corporation's acquisition of the assets of a domestic partnership, if such assets constitute substantially all of assets of the partnership, would be a domestic entity acquisition, even if the partnership is owned entirely by foreign partners and such assets did not constitute a U.S. trade or business of the foreign partners, in the same manner as if such assets were acquired from a domestic corporation under current law.

Further, the proposal would expand the definition of domestic entity acquisition to include the direct or indirect acquisition of substantially all the assets constituting a U.S. trade or business of a foreign partnership (effectively treating the foreign partnership as a "domestic entity"), apparently without regard to the identity of the partners of such partnership.

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

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

KPMG observation

The proposed managed and controlled test would represent a significant departure from the standards of an inversion under current law. Under the managed and controlled test, a domestic entity acquisition could constitute a complete inversion notwithstanding that there is no actual or

deemed shareholder continuity between the foreign acquiring corporation and the domestic entity. Thus, a foreign acquiring corporation that acquires a domestic entity in an **all-cash deal** could be treated as a domestic corporation under the managed and controlled test.

The proposal's managed and controlled test also includes the substantiality test, which provides that a domestic entity acquisition would not be subject to section 7874 unless the domestic entity were larger (by fair market value) than the foreign acquiring corporation. If a foreign acquiring corporation acquires substantially all of the assets of a single trade or business of a domestic corporation, the substantiality test would appear to compare the fair market value of the foreign acquiring corporation with the fair market value of the entire domestic corporation, rather than just the fair market value of the acquired business. Further, even if a substantiality test is included in the managed and controlled test, it is likely that the substantiality test would incorporate the principles of the NOCD rules as well as other anti-abuse rules contained in the section 7874 regulations or the principles of the "Helen of Troy" regulations. If applied, these rules would generally increase the relative value of a domestic entity for purposes of measuring substantiality.

Definition of "managed and controlled": The proposal does not include a definition of "managed and controlled." Other countries that use a similar standard for determining tax residency generally look to factors such as (1) where senior management is located, (2) where business operations are conducted, (3) legal factors (e.g., jurisdiction of incorporation, location of registered office, etc.), (4) residence of shareholders and directors, and (5) where key decisions are made, with the last factor generally being given the most weight. Various U.S. legislative proposals direct the regulations to provide that the managed and controlled test is satisfied if substantially all of the executive officers and senior management are based or primarily located within the United States.

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

State and local tax

SALT considerations of select administration proposals

Replacing BEAT with SHIELD. The administration proposes to eliminate the BEAT regime and replace it with SHIELD. Under the SHIELD provisions, a domestic corporation that is a member of a financial reporting group would not be allowed to deduct certain payments made to foreign related or unrelated parties unless the foreign party that receives the payment faces an effective tax rate that exceeds a specified minimum tax level.

Unlike the BEAT, which was structured a separate minimum tax regime, the SHIELD provisions would disallow deductions for certain payments by domestic entities to foreign parties. The denial of such deductions would increase the taxpayer's federal taxable income, which is generally the starting point in computing state taxable income. The repeal of the BEAT would have almost no direct effect on the states. The only state that currently taxes BEAT is Alaska, which requires taxpayers to pay tax on BEAT apportioned to Alaska using the taxpayer's corporate income tax apportionment percentage. However, many taxpayers elected to waive certain deductions to mitigate the BEAT liability, which resulted in increased state taxable income. The repeal of BEAT would likely eliminate this unintended result at the state level.

For rolling conformity states, if the deductions are disallowed for federal tax purposes under the proposed SHEILD regime, then they would be disallowed for state tax purposes as well. In fixed

conformity states, SHIELD would not apply until conformity legislation is passed, which would require state modifications to correctly reflect the state income tax base. Many states currently have provisions that limit deductibility for certain expenses paid or accrued to related parties – both domestic and foreign related parties. Those provisions generally apply to interest expenses and certain intangible-related expenses and provide certain statutory exceptions which, if met, eliminate the add back. If the expenses affected by the administration's proposed SHIELD provisions overlap with those subject to add back under existing state rules, possible conflicts could arise if expenses disallowed under SHIELD would not have been added back under the state statute because they fell within an allowed exception.

Further restrictions on deductibility of interest: In addition to maintaining the TCJA changes to section 163(j), the administration has proposed new limitations on the deductibility of interest expenses for members of certain multinational groups. The new limitations are aimed at taxpayers that reduce their U.S. tax by over-leveraging their U.S. operations relative to those located in lower-tax jurisdictions. Under the proposal, the interest deductions of members of a financial reporting group (defined as a multinational group preparing consolidated financial statements under GAAP or IFRS) would be limited if the member's net interest expense for financial reporting purposes (computed on a separate company basis) exceeds the member's proportionate share of the financial reporting group's net interest expense reported on the group's consolidated financial statements. A member's proportionate share of the financial reporting group's net interest expense would be determined based on the member's proportionate share of the group's earnings (computed by adding back net interest expense, tax expense, depreciation, depletion, and amortization) reflected in the financial reporting group's consolidated financial statements. If a financial reporting group member had excess financial statement net interest expense, a federal tax deduction would be disallowed for the member's excess net interest expense. A member of a financial reporting group that is subject to the administration's proposal would continue to be subject to the application of section 163(j), and a member that was subject to both section 163(j) and the new limitation would apply whichever of the two provisions imposed the lower limitation.

For state corporate income tax purposes, there has been much confusion and complexity around the application of section 163(j) given the differences between state and federal filing methods. For state purposes, a member of the federal consolidated group may be required to file a separate company state return and calculate state taxable income beginning with federal taxable income as if the corporation had not elected to file a federal consolidated return. This is the general approach in states that require separate returns. Also, certain states that require combined group filing start the calculation of the group's state taxable income with each group member's separate company federal taxable income. The administration's proposal would measure the new limitation by treating U.S. subgroups of a financial reporting group as a single member for purposes of applying the proposal. If a U.S. subgroup had multiple U.S. entities that were not all members of a single U.S. consolidated group for tax purposes, rules would be applied to allocate the U.S. subgroup's excess net interest expense for U.S. tax purposes among the members of the U.S. subgroup.

For state tax purposes, issues similar to those that currently exist in the states that conform to section 163(j) would appear to apply here. First and foremost, a U.S. financial reporting subgroup (the relevant member for computing the limitation) would likely include entities that do not have nexus in certain states, are required to file separately in certain states, and that are part of a state combined or consolidated group whose membership differs from the U.S. subgroup. In such cases, a state may require a separate computation of the limitation. Alternatively, the U.S. subgroup's excess net interest expense could be allocated to the state filers/or filing group members, similarly to the manner in which it is allocated if there are entities in different federal consolidated groups. Furthermore, to the extent that a taxpayer is subject to section 163(j) and the new limitation provision, the provision under which the taxpayer's interest deduction is limited may be different for state purposes. In other words, for federal tax purposes, a taxpayer may face a lower limit under the new provisions, but for state purposes the 163(j) limitation may be lower because it was computed on a separate entity basis for state purposes.

Finally, as noted above, many states currently have provisions that limit deductibility of interest or intangible related interest paid to related parties. The interaction between these state- specific provisions and the section 163(j) limitation would be further complicated if the states with such provisions conform to the administration's new interest limitation.

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