Analysis and observations of tax proposals in Biden Administration's FY 2024 budget

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Introduction

The U.S. Treasury Department released its General Explanations of the Administration's Fiscal Year 2024 Revenue Proposals (the "Green Book") on March 9, 2023. These revenue proposals are contained in the President's FY 2024 budget recommendations transmitted to Congress the same day.

Background

The Biden Administration transmitted its FY 2024 budget recommendations to Congress on March 9, 2023. [Read *TaxNewsFlash*.] In its FY 2024 budget, the administration laid out its annual spending plan for the fiscal year beginning October 1, 2023, for discretionary and mandatory programs and interest on the debt. The projected cost of the proposed expenditures is $6.584 trillion.

The administration's budget also includes its recommendations for revenue that would raise $4.7 trillion. This includes tax increases being recommended would raise approximately $6.6 trillion over 10 years (partly offset by new tax reductions including an enhanced child tax credit).

The combined effect of these spending and revenue recommendations would, according to the administration, reduce deficits by about $3 trillion over 10 years.

The administration's budget recommendations are, of course, only recommendations. Congress can accept, reject, ignore, 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.

The tax proposals, in particular, face a very uncertain fate in the current Congress with divided party control. The majorities in the House and Senate are narrow while the partisan divisions regarding tax policy are wide, making passage of any controversial tax legislation difficult.

Given such divergent views on the direction of the tax system, substantial changes to spending or revenue may prove impossible. It is possible, however, that some more limited proposals may attract bipartisan support and could be included in near-term legislation.

KPMG observation

With a divided Washington and slim prospects for enactment of the Green Book proposals, one might ask whether these proposals have any relevance. The answer to that is they are relevant for a few reasons.

First, these budgetary proposals are relevant to the forthcoming 2024 elections. The administration has set forth its vision of what the tax system should be, and that will no doubt become a theme of the 2024 presidential and congressional elections.

Second, the international proposals included in today's budget are partly designed to speak to readers outside the United States. Countries actively negotiating the Pillar One and Pillar Two proposals through the OECD are likely paying close attention to the administration's proposals. Certain of the Green Book international tax proposals will likely be seen as a reassurance of the United States' commitment to the OECD's project.

Finally, today's release is important because these budgetary proposals, once released, never truly disappear. These ideas have a long shelf life in the tax policy world and are likely to reappear in various formats in the years (perhaps decades) to come.

Tax proposals

Many of the corporate, international, individual, and investment tax proposals in the Biden Administration's budget for FY 2024 are familiar, having been previously proposed its FY 2022 budget and its FY 2023 budget or in the Build Back Better Act that was approved in 2021 by the then Democrat-controlled House. Still, modifications continue to be made to those proposals, including further changes to international tax proposals designed to conform to guidance from the OECD with regard to its BEPS Pillar Two plan. Several new proposals have also been added. Some of the important proposals are listed below.

Corporate and international tax proposals

Corporate and international revenue-raising proposals include:

- Increasing the statutory corporate rate to 28%
- Increasing the excise tax rate on repurchases of corporate stock to 4%
- Revising the global minimum tax regime and limiting inversions
- Adopting an undertaxed profits rule
- Repealing the deduction for foreign-derived intangible income
- Reforming the taxation of foreign fossil fuel income
- Eliminating fossil fuel preferences

Individual and investment-related tax proposals

Individual and investment tax proposal include the following:

- Increasing the top individual income tax rate to 39.6%
- Taxing long-term capital gains and qualified dividends at ordinary rates for taxpayers with adjusted gross income exceeding $1 million
- Imposing a minimum tax on wealthy taxpayers
- Increasing the net investment income tax rate and additional Medicare tax rate for high-income taxpayers
- Apply the net investment income tax to pass-through businesses of high-income taxpayers
- Taxing carried interest income as ordinary income
- Prevent basis shifting by related parties through partnerships
- Strengthen limitation on losses for noncorporate taxpayers
- Modify estate and gift tax rules
- Repeal deferral of gain from like-kind exchanges
- Providing additional funding for tax administration to improve compliance

Tax credit-related proposals

In addition to its revenue-raising proposals, the Biden Administration also included as part of its long-term plans a number of tax credits and preferences for social programs and income support, including:

- Expand the Child Tax Credit and make permanent full refundability and advanceability
- Make permanent the American Rescue Plan Act expansion of the Earned Income Tax Credit for childless workers
- Make permanent the Inflation Reduction Act expansion of Affordable Care Act (ACA) premium tax credits

Descriptions of provisions

Most of the proposals contained in the president's budget were previously proposed in his FY 2022 and FY 2023 budgets or in the Build Back Better Act. For those, the descriptions in KPMG's previous publications will be useful (read ***TaxNewsFlash-Biden Tax Agenda***). Descriptions of new proposals and modifications to previous proposals are set out below with observations.

Business taxation

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%, effective for tax years beginning after December 31, 2022. For fiscal year corporations with a tax year that straddles January 1, 2023 (i.e., a tax year beginning in 2022 and ending in 2023), 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 2023.

KPMG observation

The administration states that this proposal, estimated by Treasury to raise more than $1.3 trillion over 10 years, is an administratively simple way to raise revenue to pay for the administration's fiscal priorities, increase progressivity, and help reduce income inequality. Implicitly recognizing 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.

The proposal would "blend" the current and proposed tax rates for fiscal years that begin in 2022 and end in 2023. 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.

The proposal, if enacted, would represent the second major change to the corporate income tax rate in seven years. These rate changes can increase the importance of the timing of income and deductions, and can affect the value of tax attributes such as carryovers of net operating losses (NOLs), capital losses, and deferred interest deductions under section 163(j). For example, a corporation's deduction in a 2020 tax year could have potentially offset income that was or would be taxed (i) at 21% if the deduction was absorbed in the 2020 tax year, (ii) at 35% in a pre-TCJA year if the deduction created or increased a NOL in 2020 and the NOL was carried back under the expanded loss carryback provisions enacted by the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), or (iii) at 28%, if the proposal is enacted and the deduction created or increased an NOL in 2020 and the NOL is carried forward to a year in which the proposal is effective.

Increase the excise tax rate on repurchase of corporate stock

The IRA imposed a new, non-deductible excise tax (the "stock repurchase excise tax") on repurchases of stock of certain publicly-traded corporations. In general, the stock repurchase excise tax applies to repurchases of stock by a publicly traded domestic corporation (a "covered corporation") that occur after December 31, 2022. This tax generally applies at a rate of 1% of the fair market value ("FMV") of any stock of a covered corporation that is repurchased by the corporation during its tax year. The statute defines a repurchase to include any redemption within the meaning of section 317(b) and any other transaction determined by the Secretary to be economically similar to a redemption. The statute also treats certain acquisitions of stock of a covered corporation by affiliates of that covered corporation as repurchases. The annual FMV of a covered corporation's repurchased stock is reduced by certain exceptions and reductions, generally including the FMV of the covered corporation's stock that is issued during the tax year. The statute also applies the stock repurchase excise tax to certain acquisitions of the stock of a publicly-traded foreign corporation by the U.S. subsidiaries of that foreign corporation.

The proposal would increase the rate of tax imposed on stock repurchases to 4% (from 1%) for repurchases of stock after December 31, 2022.

The Green Book estimates that the proposal would raise almost $4 billion in 2023 and approximately $238 billion between 2024 and 2033.

KPMG observation

Stock repurchases or "buybacks" are reported to have reached a record $1.2 trillion in 2022, and buyback announcements have continued on a record pace in the first quarter of 2023. This suggests that the 1% stock repurchase excise tax has not significantly influenced corporate decision-making with respect to stock buybacks. The proposal, by increasing the cost of a stock buyback, may cause at least some corporations to reevaluate their buyback plans, or alternatively would raise additional revenue from corporations that choose to implement stock buybacks.

The proposal would increase the rate of the stock repurchase excise tax but appears to otherwise leave the statutory provision unaffected. Thus, certain existing issues regarding the stock repurchase excise tax would remain and take on greater importance. For instance, in a rule of interest to inbound corporations, the statute as enacted in the IRA imposes the stock repurchase excise tax on a U.S. subsidiary of foreign, publicly-traded corporation to the extent the U.S. subsidiary acquires its foreign parent's stock from an unrelated seller. This rule was anticipated to have some effect with respect to stock-based compensation plans, but otherwise was not expected to have a broad reach, given that U.S. subsidiaries generally do not engage in large scale acquisitions of their foreign parents' stock on the market. However, in interim guidance regarding the stock repurchase excise tax (Notice 2023-2), Treasury announced a potentially significant expansion of the scope of this rule, to impose the tax when the U.S. subsidiary "funds by any means" its foreign parent's repurchase of stock and the funding was undertaken with a principal purpose of avoiding the stock repurchase excise tax. Moreover, Treasury included in the notice an irrebuttable presumption that a funding (other than a distribution) was undertaken with a tax avoidance purpose if the foreign parent repurchased its stock within two years of the funding. The scope of this "funding rule" is uncertain, because the phrase "funds by any means" is inherently vague and because there are no exceptions for ordinary course transactions or for unrelated short-term financing (such as occurs in everyday cash pooling activities). This uncertainty is exacerbated by the *per se* presumption that a funding was undertaken with a tax avoidance motivation. The significance of this *per se* rule would increase if it were to be retained in temporary or final regulations and if the tax rate increases to 4%.

Tax corporate distributions as dividends

The administration seeks to expand the scope of corporate distributions that are treated as dividends. The Green Book asserts that corporations have devised a number of ways to avoid dividend characterization of certain distributions of property, such as through certain transactions that reduce a corporation's earnings and profits but do not result in a reduction in a corporation's dividend paying capacity. The administration views these transactions as inconsistent with a corporate tax regime in which earnings and profits are viewed as measuring a corporation's dividend-paying capacity.

Prevent elimination of earnings and profits through distributions of certain stock with basis attributable to dividend equivalent redemptions:

The proposal would amend section 312(a)(3) to provide that the reduction to earnings and profits (E&P) of a corporation on its distribution of certain "high-basis stock" would be determined without regard to basis adjustments resulting from actual or deemed dividend equivalent redemptions or any series of distributions or transactions undertaken with a view to create and distribute high-basis stock of any corporation.

The proposal would be effective on the date of enactment.

KPMG observation

In general, a corporate distribution is treated as a dividend to the extent made out of E&P for the year of distribution (computed as of the close of the year without diminution by reason of any distributions made during the year), or from E&P accumulated in prior years. To the extent a distribution exceeds the amount of available E&P, the distribution generally is applied against (and reduces) the shareholder's basis in the corporation's stock, and to the extent in excess of such basis is treated as gain from the sale or exchange of property. The amount of a distribution is based on the amount of money plus the fair market value of other property received.

Subsequent to the repeal of the *General Utilities* doctrine in 1986, corporations generally recognize gain on the distribution of appreciated property; losses on the distribution of loss property are not allowed. However, where the distributing corporation distributes loss property, its E&P generally are reduced (but not below zero) under section 312(a)(3) by its adjusted basis in the distributed loss property.

For example, assume a corporation with significant amount of current and accumulated E&P distributes property with a value of $70, in which it has an adjusted basis of $100. The corporation's $30 loss on the distribution is disallowed. The corporation's E&P (but not its current E&P) generally are reduced by its $100 basis in the distributed property (the corporation generally does not reduce its E&P by the amount of the disallowed loss, because such a reduction would be duplicative).

When a corporation redeems (or constructively redeems) its stock in exchange for money or other property, the shareholder generally is treated under section 302 either (i) as engaging in a sale or exchange of the stock, or (ii) as receiving a distribution of property to which section 301 applies (*i.e.*, a "dividend equivalent" redemption). Where a shareholder receives a distribution of property from a corporation in a dividend equivalent redemption, the distribution is treated as a dividend to the extent of available E&P. As with other distributions, to the extent such a redemption distribution exceeds the amount of available E&P, the distribution generally is applied against (and reduces) the shareholder's basis in the corporation's stock, and then is treated as gain from the sale or exchange of property. If the redeemed shareholder's basis in the redeemed stock is not fully recovered under section 301(c)(2) (either because the distribution was out of E&P or due to basis that exceeds the section 301(c)(2) amount), the shareholder's basis in any non-redeemed stock it owns in the corporation is increased by the shareholder's unrecovered basis in the redeemed stock. If the shareholder no longer directly owns shares in the redeeming corporation (*e.g.*, when the redemption

is treated as dividend equivalent solely as a result of constructive stock ownership), the shareholder's unrecovered basis in the redeemed shares can "jump" to other shares in the same corporation held by a related party. *See, e.g.,* Treas. Reg. section 1.302-2(c), Example 2.

Corporate taxpayers can use the rules described above to shift basis in certain shares to other shares (including through redemptions and section 304 transactions), and thereby create a loss in such other shares. The proposal would modify the E&P rules under section 312(a)(3), to provide that the distributing corporation's E&P reduction would be determined without regard to basis adjustments resulting from actual or deemed dividend equivalent redemptions.

The proposal appears limited to the E&P consequences of these transactions; it does not appear to affect or reduce the tax basis in the distributed "high-basis" shares. Such a basis adjustment might not be necessary, given that under current law the distributing corporation's loss in the distributed shares generally would be disallowed and the shareholder's basis in the distributed shares would be equal to the fair market value of such shares as of the distribution date.

Prevent use of leveraged distributions from related corporations to avoid dividend treatment

The Green Book proposal would treat a leveraged distribution from a corporation to its shareholders that is treated as a recovery of basis as the receipt of a dividend directly from a related corporation to the extent the funding corporation funded the distribution with a principal purpose of not treating the distribution as a dividend from the funding corporation.

This proposal would be effective for transactions occurring after December 31, 2023.

KPMG observation

As noted above, a corporate distribution is treated as a dividend to the extent it is out of current or accumulated E&P. However, a corporation that has no E&P can borrow funds with which to make a distribution, with the distribution resulting in a tax-free basis recovery to the recipient shareholder. The IRS has periodically sought to challenge these so-called leveraged distributions. Initially, the IRS argued that such distributions were anticipatory distributions of future profits and thus should be taxed as dividends; courts largely rejected these arguments, even in situations where the distributing corporation's borrowings were guaranteed by federal agencies. *See Gross v. Commissioner*, 236 F.2d 612 (2d Cir. 1956) (statutorily overruled in present section 312(i) in the context of federally insured loans) and *Commissioner v. Godley's Estate*, 213 F.2d 529 (3d Cir. 1954). The IRS lost a similar case in *Falkoff v. Commissioner*, 604 F.2d 1045 (7th Cir. 1979), where a parent corporation borrowed funds from a bank in the last days of a tax year to fund a return of basis distribution, followed days later (in the succeeding tax year) by a sale of real estate by its subsidiary corporation and use of those proceeds to repay the bank loan. The court noted that the taxpayer's intentional use of the timing aspects of the tax system to distribute funds in a year prior to the creation of E&P simply delayed rather than denied tax, due to the corresponding reduction in stock basis under section 302(c)(2).

More recently, in *Illinois Tool Works v. Commissioner*, T.C. Memo. 2018-121, the IRS unsuccessfully challenged a taxpayer's leveraged distribution. There, a US corporation owned a first tier CFC, which owned all of the stock of a second tier CFC. The first-tier CFC was a holding company and held no other substantial assets and had no E&P. The second-tier CFC had significant direct and indirect business operations and a large amount of E&P. The second-tier CFC loaned funds to the first-tier CFC, which were then distributed in a section 301 return of basis distribution to its US shareholder. The court held the loan to the first-tier CFC to be a *bona fide* debt. In addition, the court declined to adopt the IRS request to deploy one or more judicial anti-avoidance doctrines (such as a step

transaction, economic substance doctrine, or conduit theory), to combat what it perceived as avoidance of the purposes of subpart F. The court found that because the advance from the second-tier CFC to the first-tier CFC was a *bona fide* loan, and because the second-tier CFC could not directly pay a dividend to the US shareholder (who did not directly own any stock in the second-tier CFC), the first-tier CFC did not act as a conduit.

It is not clear the extent to which the proposal is aimed at transactions similar to those at issue in the *Falkoff* and *Illinois Tool Works* cases, where distributions are made by an E&P-free corporation with funds directly or indirectly sourced from a related corporation. The proposal would treat what is otherwise a return of basis distribution from one corporation as the receipt of a dividend directly from a related corporation, to the extent the related corporation funds the distributing corporation with a principal purpose of not treating the distribution as a dividend from the funding corporation. It appears that this proposal would capture a distribution by a brother corporation of funds borrowed from a sister corporation. However, both *Falkoff* and *Illinois Tool Works* involved distributions arguably "funded" within a corporate chain, and it is not clear the proposal would literally apply in many such cases. For example, if a parent corporation borrowed funds to make a distribution, with the borrowing supported by the assets of a subsidiary corporation (and to be repaid by a distribution from the subsidiary in a subsequent tax year), seemingly there could be no "purpose" of avoiding a dividend from the subsidiary to the shareholders of parent given that parent, not parent's shareholders, own the stock of subsidiary. The Tax Court in *Illinois Tool Works* cited this notion in rejecting the IRS's conduit argument. However, this might reflect the manner in which the proposal is articulated rather than its intent. The Green Book's statement of_purposes underlying the proposal would seem to reach this sort of leveraged distribution, and this issue could be addressed in legislative language implementing the proposal.

The proposal does not specify how it would determine whether "a principal purpose" exists. In other potentially analogous contexts, "per se" funding rules have been promulgated to deem a principal purpose to exist where a "funding" occurs sufficiently close in time to the transaction at issue. For instance, "per se" funding rules are included in the section 385 regulations, which are intended to recharacterize certain related party indebtedness as equity, and in Notice 2023-2, which relates to the new stock repurchase excise tax (discussed above). The potential reach of those *per se* rules is extraordinarily broad, pulling in transactions with a general temporal relationship to a distribution or stock repurchase, regardless of whether there might be any factual or causal connection. These *per se* rules are controversial, and they have yet to be tested in a reported court decision.

If a *per se* rule were imposed as part of (or in connection with) this proposal, we would anticipate the need for exemptions for ordinary course transactions (such as intercompany sales of inventory for resale) and unrelated short-term funding arrangements (such as routine intercompany payables and cash pooling arrangements). We would also anticipate the need for a series of rules to address the collateral consequences of the fiction of a dividend distribution from the funding corporation. For example, assume that in Year 1, a parent corporation borrowed funds from an unrelated lender and distributed the proceeds to its shareholders in a leveraged distribution, and that in Year 2 a non-consolidated subsidiary corporation distributed cash to the parent corporation (out of the subsidiary's E&P), which the parent corporation used to repay the borrowing. If this were to be treated as though the subsidiary corporation had paid a dividend directly to the shareholders of the parent corporation, what adjustments might be necessary? What if the parent corporation owned less than all of the stock in the subsidiary? Could this allow for subsequent distributions by the subsidiary to its minority owners to be return of basis distributions (rather than dividends)? Would there be a need to adjust the parent corporation's shareholders' bases in the stock of the parent, or the parent's basis in the stock of the subsidiary (or of any intervening entities if the subsidiary is lower-tier), if the distribution were considered an extraordinary dividend under the rules of section 1059? If the proposal were to apply to distributions from CFCs, would there be a need to provide coordinating rules with the rules in subpart F (including the rules relating to distributions of PTEP and basis adjustments under section 961)? The one thing that seems relatively clear is that this proposal can reasonably be expected to add significant additional complexity.

Treat purchases of hook stock by a subsidiary as giving rise to deemed distributions

If a subsidiary corporation acquires, in exchange for cash or other property, stock issued by a direct or indirect corporate shareholder (hook stock), the issuing corporation does not recognize gain or loss (or any income) under section 1032 upon the receipt of the subsidiary's cash or other property in exchange for issuing the hook stock.

The proposal would disregard a subsidiary's purchase of hook stock for property. Instead, the money or other property used to purchase the hook stock would be treated as a deemed distribution from the purchasing subsidiary (through any intervening entity) to the issuing corporation. The hook stock would be treated as being contributed by the issuer (through any intervening entities) to the subsidiary. The proposal would also grant the Secretary and her delegates authority to prescribe regulations to treat purchases of interest in shareholder entities other than corporations (*i.e.*, partnerships) in a similar manner and provide rules related to hook stock within a consolidated group.

The proposal would be effective for transactions occurring after December 31, 2023.

KPMG observation

There has been longstanding concern that certain issuances of stock to other corporations in nonrecognition transaction may result in the corporate transferee taking a tax basis of $0 in the acquired stock under general transferred basis provisions. Currently, in many cases Treas. Reg. §§ 1.1032-2 and 1.1032-3 apply to prevent the transferee corporation from taking a "zero basis" and, therefore, from having gain equal to the full value of the stock or "zero basis gain" on a disposition. However, the purchases of hook stock addressed by this proposal may not be eligible for relief from a "zero basis" issue under existing rules. Therefore, the proposal not only creates a potentially taxable dividend but also a potential tax basis of $0 (and the potential for zero basis gain) in the hook stock received by the subsidiary.

Repeal gain limitation for dividends received in reorganization exchanges

One hundred years ago, Congress enacted the predecessor to Section 356(a)(1), which currently provides that if, as part of a reorganization, a shareholder receives stock and "boot" in exchange for its stock in the target corporation, the shareholder recognizes gain, but not in excess of the boot (the so-called "boot within gain" limitation). Under section 356(a)(2), if the exchange has the effect of the distribution of a dividend, then all or part of the gain recognized by the shareholder is treated as a dividend to the extent of the shareholder's ratable share of the corporation's E&P, with the remainder of the gain treated as gain from the exchange of property (generally capital gain). In certain limited situations, the entire amount of boot can be viewed as a separate distribution (and thus as a dividend, to the extent of E&P), in the context of recapitalizations and related-party reorganizations (*see Bazley v. Commissioner*, 331 U.S. 737 (1947) and Treas. Reg. section 1.301-1(j)) and in the context of an "F reorganization" (*see* Treas. Reg. section 1.368-2(m)(3)(iii)).

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

The proposal would be effective for transactions occurring after December 31, 2023.

KPMG observation

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

Limit tax avoidance through inappropriate leveraging of parties to divisive reorganizations

Background

A divisive reorganization under sections 368(a)(1)(D) and 355 (a "Divisive Reorganization"), commonly referred to as a spin-off, a split-off, or a split-up, involves the transfer by a distributing corporation ("D") of property to a controlled corporation ("C") in exchange for C stock, followed by D's distribution of the C stock to its (D's) shareholders. Often, C also issues its debt securities or transfers money (e.g., the proceeds of borrowing or an initial public stock offering) to D as partial consideration in the exchange, which generally can be received and distributed tax-free by D to its shareholders and creditors under current law. As part of the Divisive Reorganization, C may also assume D's liabilities as part of the exchange.

Section 361(a) generally provides that D does not recognize gain or loss on its transfer of property to C solely in exchange for C stock and C securities. Section 361(b)(3) generally extends nonrecognition treatment to D's receipt of money or other property from C (i.e., "boot"), provided that D distributes such boot to its shareholders or creditors in pursuance of the plan of reorganization. In addition, section 361(c)(3) generally provides that D does not recognize gain on its distribution of C stock, C securities, or other C debt obligations to its (D's) shareholders or creditors in pursuance of the plan of reorganization.

Currently, there are a number of provisions that are intended to limit D's ability to extract value from C in a tax-free manner in connection with a Divisive Reorganization. However, Treasury identifies what it describes as two "safe harbors" that allow some extraction of value to occur in Divisive Reorganizations without D recognizing gain. First, D generally does not recognize gain if the aggregate of (i) the liabilities assumed by C and (ii) the boot transferred by C to D and then distributed by D to its creditors does not exceed the aggregated adjusted tax basis of the property D transfers to C (the "Adjusted Basis Limitation"). Second, 361(c)(3) permits the tax-free transfer of C's securities received in the exchange to D's creditors.

In addition, the Green Book notes that certain contingent liabilities that may be assumed by C are not taken into account for purposes of the Adjusted Basis Limitation. The Green Book also states that there are no adequate safeguards to ensure C's adequate capitalization or continued economic viability following a Divisive Reorganization.

Proposal

The proposal would address both the perceived "monetization" available in Divisive Reorganizations as a result of the two "safe harbors" described above, as well as the perceived potential to "overleverage" C through C's assumptions of contingent liabilities of D. These proposals generally would be effective for transactions occurring after enactment. However, the new rules would not apply to any distribution pursuant to a Divisive Reorganization described in a ruling request initially submitted to the Internal Revenue Service on or before the date of enactment (if the request has not been withdrawn and for which a ruling has not been issued or denied in its entirety as of such date).

"Eliminate excessive tax-free monetization of divisive reorganizations"

This proposal would modify the two "safe harbors" through the introduction of a new quantity, the "excess monetization amount." This amount would be equal to (a) the sum of the following four items: (i) the total amount of liabilities assumed by C, (ii) the total amount of C boot transferred to D's creditors, (iii) the fair market value of the nonqualified preferred stock transferred to D's creditors, and (iv) the total principal amount of C debt transferred to D's creditors, reduced by (b) the total adjusted bases of the assets transferred by D to C.

An excess monetization amount could cause D to recognize gain in two ways. First, D would recognize dollar-for-dollar gain equal to the lesser of D's excess monetization amount or the amount of C boot (defined as money and other property other than C debt) that D transfers to its creditors ("First Prong"). Second, D could also recognize gain if D's excess monetization amount exceeds the amount of C boot that D transfers to its creditors. Specifically, this remaining excess monetization amount would cause an equal principal amount of C debt to be treated as if sold in a taxable sale ("Second Prong").

To illustrate, if D's excess monetization amount equaled $5 billion, and D transferred $4 billion of C boot and $1 billion of C debt to D's creditors, D would recognize gain to the extent that $1 billion exceeds the adjusted basis of the C debt. This would be in addition to the $4 billion in dollar-for-dollar gain on the C boot transferred to D's creditors.

KPMG observation

The existing statutory rules serve an important business function in Divisive Reorganizations by allowing D the flexibility to reallocate its debt between its continuing business (or businesses) and the continuing business (or businesses) transferred to C. For example, consider a situation when D has a significant debt load and has historically financed its businesses through borrowings at the parent level—D may not be able or willing to service its historical debt load after spinning off a significant business, and traditional financial and business considerations might suggest that the distributed business include a reasonable amount of leverage. The debt reallocation flexibility, however, has led to certain transactions which have troubled the government and resulted in the enactment of various modifications of the Divisive Reorganization rules. The Service has struggled with this and related issues and has periodically modified the no-rule areas in its private letter rulings practice (and released proposed regulations in 2016 under the section 355 "device" and active business requirements) but has consistently provided letter rulings consistent with current law.

The current Adjusted Basis Limitation allows D to establish new debt capital structures for D and C by permitting D to transfer to its creditors, without recognizing gain, the boot received from C, up to an amount equal to D's adjusted basis in the assets transferred to C (reduced by liabilities assumed). In addition, the current Adjusted Basis Limitation does not restrict the amount of C securities that D may transfer to its creditors on a tax-free basis.

The proposal appears similar in intent to statutory language amending section 361 that was included in the legislative text of the Build Back Better Act released by the Senate Finance Committee on December 11, 2021. The House had passed a version of this legislation on November 19, 2021, but the legislation never passed the Senate. The intent both in the prior draft legislation and the current proposal appears to be to limit not only the amount of money or other property that D may transfer to creditors and the amount of D liabilities that C may assume, but also the amount of C securities that D may transfer to creditors to D's adjusted basis in assets transferred to C. By imposing such limitation, the proposal would further restrict D's ability to reallocate its debt to C on a tax-free basis in connection with a Divisive Reorganization.

The FY 2024 proposal appears to be based on the questionable premise that **all** C debt (whether or not a "security") more resembles cash than an equity interest, contrary to U.S. Supreme Court's

treatment of indebtedness that constitute "securities" for purposes of the reorganization provisions. Moreover, the proposal presents several ambiguities that presumably will be clarified in proposed legislation. First, the term "C boot" is defined as money and other property other than "C debt," which in turn is defined as securities or other debt obligations of C. The term "C boot" also excludes the assumption of liabilities by C. Accordingly, it appears that neither the assumption of liabilities by C nor C non-securities debt would be subject to the dollar-for-dollar gain recognition under the First Prong. Second, the Second Prong causes any excess monetization amount in excess of the C boot transferred to D creditors to be treated as a sale by D of a principal amount of C debt equal to the remaining excess monetization amount. The resulting gain under the Second Prong will depend on D's basis in the C debt that is deemed sold. Under section 361(a), C securities debt and C nonqualified preferred stock constitute "qualified property," the receipt of which is tax-free to D and to which D must allocate basis under section 358(a)(1). On the other hand, C non-securities debt may be received tax-free only if the distribution requirements under section 361(b)(1)(A) and (b)(3) are satisfied. The proposal as well as the prior draft legislation do not provide for amendments to the basis determination rules under section 358, and it is unclear how such rules would apply to property that is taxed under the First Prong and Second Prong. Even if section 361(b)(1)(A) and (b)(3) are satisfied, D may receive a fair market value basis in the C non-securities debt under section 358(a)(2). As a result, the amount of gain that may be recognized under the Second Prong will depend not only on the proper basis allocation under section 358 but also the stacking or ordering of C securities debt, C non-securities debt, and/or C nonqualified preferred stock that is deemed sold.

"Prevent tax avoidance through the transfer of contingent liabilities to C"

To address the perceived lack of existing safeguards to ensure C's adequate capitalization or continued economic viability following a Divisive Reorganization, the proposal would impose two additional requirements under section 355 that, if not satisfied, would result in gain recognition by D (but not D's shareholders). First, C would be required to be adequately capitalized as a result of the Divisive Reorganization. Second, C must continue to be an economically viable entity after the completion of the Divisive Reorganization. The satisfaction of these requirements would be based on all relevant facts and circumstances including (a) the projected, as well as actual, amount of contingent D liabilities assumed by C, and (b) whether C declares bankruptcy within the five-year period following the Divisive Reorganization. The fact that one or more creditors would be willing to lend to C is stated to be irrelevant to the determination. In addition, the proposal would authorize regulations to carry out the purposes of the proposal or to prevent the avoidance of tax.

KPMG observation

Under current law, a post-distribution cessation in C's business might call into question whether the "active trade or business" requirement of Section 355(b) was met. This proposal is aimed at providing further requirements that assess C's viability as a business, particularly with respect to any assumed contingent liabilities. Although the proposal identifies certain facts that would be pertinent in assessing these new requirements, it appears that the administration intends to defer to the Secretary to provide more clear guidance on what scenarios might run afoul of the intended purpose of this proposal or what mechanisms would be applied (e.g., how frequently would C's economic viability be tested or in what year would D recognize gain if C were to fail the economic viability test several years post-distribution). The proposal seems to imply that the current corporate and securities law restrictions are not enough to ensure viable controlled corporations. Query whether corresponding requirements (i) to ensure adequate capitalization of D and (ii) to ensure D is an economically viable entity following the Divisive Reorganization may be considered to prevent a perceived inappropriate retention by D of contingent liabilities.

Limit losses recognized in liquidation transactions

A shareholder of a liquidating corporation generally recognizes gain or loss on the receipt of assets from the liquidating corporation in complete liquidation under section 331, and the liquidating corporation recognizes gain or loss (subject to certain loss limitation rules) on its distribution of property to its shareholders under section 336. Under section 332, if a corporation owns stock in a subsidiary corporation that possesses 80% or more of the total vote and value of the subsidiary's outstanding stock, the 80% corporate shareholder does not recognize gain or loss on its receipt of assets from the subsidiary in complete liquidation and, under section 337, the liquidating subsidiary corporation generally does not recognize gain or loss on property distributed to the 80% corporate shareholder. (Different rules can apply with respect to liquidations of insolvent corporations.)

Section 267(f)(2) generally provides that losses recognized on sales or exchanges of property between members of a controlled group of corporations generally are deferred until the property is transferred outside the controlled group. A controlled group is defined by reference to the section 1563(a) definition and using a more than 50% of vote or value stock ownership threshold.

The proposal would modify section 267 to deny the recognition of losses with respect to the stock or securities of a liquidating corporation and the property it distributes in a complete liquidation to which sections 331 and 336 apply if the assets of the liquidating corporation remain in the controlled group after the liquidation. Treasury would be granted regulatory authority to issue guidance to allow for the deferral, rather than the denial, of such losses under the principles of section 267(f), as well to address the use of controlled partnerships to avoid these rules.

This proposal would apply to distributions occurring after the date of enactment.

The proposal is estimated to increase revenues by approximately $5.4 billion over 10 years.

KPMG observation

Unlike similar proposals that had been included in versions of the proposed BBBA, the proposal would apply not only to disallow losses in the stock of the liquidating corporation, but also to disallow the liquidating corporation's loss on the liquidating distribution of its assets. However, unlike certain prior proposals, the Greenbook proposal does not appear to apply to dissolutions of insolvent subsidiaries, which may result in worthless stock deductions for the shareholder under section 165(g) and loss for the dissolving corporation on the deemed sale of its assets.

The proposal indicates that the change is intended to address "*Granite Trust*" planning as well as loss recognition on property held by the liquidation corporation. At a high level, a *Granite Trust* transaction generally involves a transaction in which a parent corporation attempts to recognize a loss on the stock of a subsidiary (and avoid the application of the tax-free subsidiary liquidation rules of section 332) by reducing its stock ownership in a controlled subsidiary below the relevant 80% stock ownership requirement, thereby positioning it to recognize a stock loss under section 331 upon the subsidiary's complete liquidation. This transaction can also result in the recognition of losses on property held by the liquidating corporation under section 336. The parent corporation, under current law, may effectively reduce its stock ownership in the subsidiary below 80% by selling a sufficient amount of its stock in the subsidiary (if necessary, to any person outside of the tax-consolidated group of which the parent corporation is a member, due to the consolidated stock ownership aggregation rule in Treas. Reg. section 1.1502-34). Such a transaction often takes the form of a sale of, say, 30% of the subsidiary's stock to a related partnership or foreign corporation. Under current law, section 267(f) can apply to defer or disallow losses between corporations within the same controlled group and thus can defer the parent's loss on the 30% interest in the stock of the liquidating corporation if the transfer is not a dividend-equivalent exchange under section 304(a) in which basis in the transferred minority interest is credited to the parent's remaining 70% interest in the liquidating

subsidiary. However, section 267(f) does not apply to the parent's loss on its remaining 70% stock interest in the liquidating corporation and the liquidating corporation's losses on property distributed in liquidation. The proposed change, however, would effectively provide that no loss may be recognized by the parent (distributee) corporation with respect to the stock or securities of the liquidating corporation exchanged for the property of the liquidating corporation in the liquidation and by the liquidating (distributing) corporation with respect to property distributed to the parent corporation in the liquidation. If enacted, the proposed modification can be anticipated to significantly reduce the volume of *Granite Trust* type tax planning, which has been around for some time (the *Granite Trust* case was decided in 1943).

The proposal would create a default rule that would deny (rather than defer) both the shareholder's stock loss as well as the liquidating corporation's asset-level loss, thus disallowing any deduction with respect to an economic loss. However, in apparent recognition of the unfairness of such a rule, the proposal would explicitly grant Treasury regulatory authority to provide for deferral, rather than denial, of the losses under the principles of section 267(f). If the proposal is enacted, it is unclear whether there would be a gap period (until deferral regulations are issued) in which economic losses would be denied.

While the proposal would deny stock and asset losses within the controlled group, it would not appear to affect the timing of a stock or asset loss recognized by or with regard to an otherwise unrelated minority shareholder in the liquidating corporation.

Conform definition of "control" with corporate affiliation test

The proposal would amend the "control test" under section 368(c) to adopt the "affiliation test" under section 1504(a)(2). Therefore, "control" would be defined as the ownership of at least 80% of the total voting power and at least 80% of the total value of stock of a corporation. For this purpose, stock would not include certain preferred stock that meets the requirements of section 1504(a)(4) (certain non-voting, "plain vanilla" preferred stock).

Currently, for purposes of defining "control" as that term is used in connection with tax-free transfers of assets to controlled corporations in exchange for stock (section 351 exchanges), tax-free distributions of controlled corporations (such as in spin-offs), and tax-free corporate reorganizations, "control" is defined in section 368(c) as the ownership of 80% of the voting stock and 80% of the number of shares of all other classes of stock of the corporation. In contrast, "control" for purposes of the "affiliation test" under section 1504(a)(2) (which is relevant to determining which corporations can join in the filing of a consolidated returns) is defined by reference to the direct or indirect ownership by a parent corporation of stock in another corporation that possesses at least 80% of the total voting power and at least 80% of the total value of the other corporation's stock (excluding certain plain vanilla preferred stock). Several other Code provisions cross-reference and incorporate either the control test or the affiliation test.

The proposal notes that by allocating voting power among the shares of a corporation, taxpayers can manipulate the section 368(c) control test in order to qualify or not qualify, as desired, a transaction as tax-free. For example, a taxpayer may structure a transaction in this manner to avoid tax-free treatment in order to recognize a loss. In addition, the absence of a value component under this standard allows corporations to retain control of a corporation but to "sell" a significant amount of the value of the corporation tax-free. The proposal also notes that a uniform ownership test would reduce complexity currently caused by the two tests.

The proposal would be effective for transactions occurring after December 31, 2023.

KPMG observation

This proposal is consistent with previous changes made to the affiliation test. For example, prior to 1984, the affiliation test required ownership of 80% of the voting stock and 80% of the number of shares of all other classes of stock of the corporation, similar to the control test in section 368(c). Congress amended the affiliation test in 1984 in response to similar concerns that corporations were filing consolidated returns under circumstances in which a parent corporation's interest in the issuing corporation was being manipulated. Similar proposals to conform section 368(c) with section 1504(a)(2) have been made through the years, including by the Clinton and Obama Administrations, but those proposals did not advance in the legislative process.

Strengthen limitation on losses for noncorporate taxpayers

In general, the section 461(l) excess business loss limitation limits the extent to which trade or business losses of a noncorporate taxpayer may be used to offset other income of the taxpayer. The excess business loss limitation is calculated by taking the aggregate deductions attributable to trades or businesses over the sum of aggregate gross income or gain attributable to trades or businesses, plus an annual threshold amount. Under current law, any excess business loss which is suspended is carried over to the taxpayer's next tax year as a net operating loss (NOL).

Currently, the excess business loss limitation regime is set to sunset, such that losses will no longer be limited after December 31, 2028. The proposal would remove the provision's present sunset date and make the excess business loss limitation permanent. Significantly, the proposal would also change the manner in which the excess business loss is carried over to a subsequent year. Under the proposal, instead of the excess business loss becoming an NOL in the taxpayer's following year, the excess business loss would become a deduction attributable to a trade or business loss which would be subject to the section 461(l) limitation in the taxpayer's subsequent tax year. This proposal would apply for tax years beginning after December 31, 2023.

KPMG observation

The proposal, which has been recommended by the administration on prior occasions, would represent a substantial change to the manner in which the excess business loss regime currently operates. By modifying the provision to have excess business losses "re-tested" in the taxpayer's subsequent tax year—as compared to treating as an NOL in the following year—a taxpayer's ability to claim trade or business deductions could be significantly limited. Net operating loss deductions for tax years beginning after December 31, 2020, are limited to 80% of taxable income and can generally offset any type of income. In contrast, if the loss is required to be re-tested, it may take many more years for the taxpayer to be able to utilize the benefit of such losses. Further, if a taxpayer might have consecutive years of excess business losses, the proposed modification may significantly compound the delay in utilization of such losses.

KPMG observation

This proposal could result in the permanent elimination of the taxpayer's excess business losses. For example, if a taxpayer had a small business that generated significant losses and did not have any other sources of income before the business ceases, the taxpayer could have an excess business loss carryover. If the taxpayer then proceeded to earn only non-business income (including wage income as an employee), such cumulative excess business losses – in excess of the amount afforded to the taxpayer through the annual threshold construct – could be functionally lost to the taxpayer under this proposal. Furthermore, should the taxpayer die without using his or her cumulative excess business losses, then it would appear that the taxpayer's remaining excess

business losses could be permanently lost. The proposal would create an excess business loss limitation regime which would stand in stark contrast to other loss limitations (such as section 469) which generally afford a taxpayer a mechanism to utilize losses before such losses may be permanently eliminated.

Accelerate and tighten rules on excess employee renumeration

Under section 162(m)(1), a deduction limit of $1 million generally applies to compensation paid to covered employees (the principal executive officer, principal financial officer, and the three most highly compensated executive officers for the tax year). The American Rescue Plan Act (ARPA) expanded the set of applicable employees under section 162(m) to include an additional "five highest compensated employees" beyond those already covered by section 162(m), beginning in tax years after December 31, 2026. The president's proposal would accelerate the definition of covered employees to tax years after December 31, 2023. A similar proposal has been included in prior Green Books by the administration.

The president's proposal would apply rules similar to the section 414 aggregation rules for covered health insurance providers (bringing in the single employer concept under subsection (b), (c), (m), or (o) of section 414) to the general rule under section 162(m) and expand upon the definition of applicable employee renumeration (specifically referencing performance-based compensation, commissions, post-termination compensation, and beneficiary payments, whether or not such remuneration is paid directly by the publicly held corporation).

The proposal would be effective for tax years beginning after December 31, 2023. This proposal is estimated to increase revenue by $14.2 billion over the 10-year budget window.

KPMG observation

Entities subject to section 162(m) would need to consider the potential impact of the controlled group rules which may pull in additional related entities. Further, the accelerated effective date to include another five highest paid employees (a term that does not appear limited to "officers") on an annual basis would result in a significant increase to the number of covered employees affecting the compliance burden (at least 10 or more in most instances on an annual basis).

International taxation

Glossary

BEAT	base erosion anti-abuse tax
BEPS	base erosion and profit shifting
CFC	controlled foreign corporation
COGS	cost of goods sold
CbCR	country-by-country reporting
ETR	effective tax rate
ETI	extra-territorial income
EAG	expanded affiliated group
EBITDA	earnings before interest, taxes, depreciation and amortization
DSBA	significant domestic business activities
FATCA	Foreign Account Tax Compliance Act
FOGEI	foreign oil and gas extraction income

FORI	base erosion anti-abuse tax
FSC	foreign sales corporation
FSBA	foreign substantial business activities
FTC	foreign tax credit
GAAP	Generally Accepted Accounting Principles
G7	The Group of Seven is an intergovernmental organization consisting of Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.
G20	The Group of Twenty is an international forum for the governments and central bank governors from 19 countries and the European Union.
GILTI	global intangible low-taxed income
IIR	income inclusion rule
IFRS	international financial reporting standards
IGA	intergovernmental agreement
JCT	Joint Committee on Taxation
NOL	net operating loss
NOCD	non-ordinary course distribution rule
OECD	Organization for Economic Cooperation and Development
Pillar One	Pillar One of the OECD initiative would provide "market jurisdictions" a new taxing right that goes beyond the arm's-length principle and permanent establishment standard.
Pillar Two	Pillar Two of the OECD initiative would secure a comprehensive agreement on a regime for global minimum taxation that is intended to ensure that all internationally operating businesses pay at least a minimum level of tax on their income in each jurisdiction regardless of where they are headquartered or the jurisdictions in which they operate.
QBAI	qualified business asset investment
R&D	research & development
REIT	real estate investment trust
RIC	regulated investment company
TLAC	total loss absorbing capacity
UPE	ultimate parent entity
UTPR	undertaxed payments rule
USSH	United States shareholder

Revise the global minimum tax regime, limit inversions, and make related reforms

Revise global minimum tax regime with respect to controlled foreign corporation earnings

The Green Book contains substantively identical proposals to the existing global minimum tax system that were previously included in the FY 2022 Green Book. The Green Book also includes additional proposals that are similar to the version of the Build Back Better Act (BBBA) that passed the House of Representatives in November 2021

Substantively identical proposals from the prior FY 2022 Green Book:

- Increasing the GILTI rate from 10.5% to 21% (by a combination of decreasing the section 250 deduction from 50% to 25% and increasing the corporate tax rate to 28%)
- Eliminating QBAI
- Determining GILTI income and limiting foreign tax credits on a jurisdiction-by-jurisdiction basis
- Allowance of credit for foreign taxes paid under a foreign income inclusion rule
- Repeal of the high-tax exception for both subpart F and GILTI

Read KPMG's May 31, 2021 report on the FY 2022 Green Book proposals: **KPMG report: Analysis and observations of tax proposals in Biden Administration's FY 2022 budget** [PDF 1.4 MB] (116 pages)

Additional proposals that are similar to the House-passed BBBA:

- Unlimited tested loss carryforward for countries with net tested loss
- Reduce haircut on GILTI taxes from 20% to 5%
- Allow foreign tax credit carryforward for GILTI category (10-year carryforward)

Read a **KPMG report** [PDF 2.4 MB] (210 pages) dated November 19, 2021 that provides analysis and observations about the similar proposal in the House-approved BBBA. The Green Book differs from the House-approved BBBA in two ways. First, the Green Book does not repeal the carryback of foreign tax credits. Second, the Green Book would allow a 10-year carryforward with respect to the GILTI category, whereas the House-approved BBBA would have allowed only a five-year carryforward until December 31, 2030, and a 10-year carryforward thereafter.

The Green Book's proposal to reduce the section 250 deduction would be effective for tax years beginning after December 31, 2022. All other proposals to the existing international tax system would be effective for tax years beginning after December 31, 2023.

Limit the deduction for dividends received from non-controlled foreign corporations

The Green Book contains a proposal similar to the House-approved BBBA limiting the availability of the dividend received deduction under section 245A to dividends received from controlled foreign corporations (CFCs); however, the Green Book proposal would continue to allow a partial DRD for non-CFC dividends impacted by the proposal. [Read a **KPMG report** [PDF 2.4 MB] (210 pages) dated November 19, 2021 that provides analysis and observations about the similar proposal in the House-approved BBBA.] Under current law, section 245A provides a deduction for the foreign-source portion of a dividend received by a U.S. shareholder from a specified 10% owned foreign corporation (a "section 245A DRD"), subject to the U.S. shareholder satisfying the holding period requirements of section 246(c). The Green Book proposal limits the availability of section 245A DRD to dividends distributed by CFCs or by certain other qualified foreign corporations. Other than CFCs, the term qualified foreign corporation is intended to include corporations that are incorporated in a U.S. territory and those corporations that are eligible to claim the benefits of a comprehensive income tax treaty with the United States. The Green Book proposal would provide that a U.S. shareholder that owns at least 20% of the stock (vote and value) of a qualified foreign corporation that is not a CFC may claim a 65% (reduced from 100%) section 245A DRD. If the 20% ownership threshold is not met with respect to the qualified foreign corporation that is not a CFC, the U.S. shareholder would only be entitled to a 50% section 245A DRD.

Reform the treatment of deductions properly allocable to exempt income

The Green Book's proposal to expand the application of section 265 to disallow deductions allocable to a class of foreign gross income that is exempt from tax or taxed at a preferential rate through a deduction (e.g., a global minimum tax inclusion with respect to which a section 250 deduction is allowed or dividends eligible for a section 245A deduction) and repeal section 904(b)(4) is substantively identical to the prior proposal in the FY 2022 Green Book. Read KPMG's May 31, 2021 report on the FY 2022 Green Book proposals: **KPMG report: Analysis and observations of tax proposals in Biden Administration's FY 2022 budget** [PDF 1.4 MB] (116 pages)

The Green Book's proposal would be effective for tax years beginning after December 31, 2023.

Limit the ability of domestic corporations to expatriate

The Green Book's anti-inversion proposal is substantially similar to the anti-inversion proposal in the FY 2022 Green Book. [Read **KPMG report: Analysis and observations of tax proposals in Biden Administration's FY 2022 budget** [PDF 1.4 MB] (116 pages).] In general, the proposal would reduce the ownership percentage for complete inversion (where the foreign acquirer is treated as a domestic corporation for U.S. tax purposes) from at least 80% to greater than 50%, and would eliminate the current-law 60% test for surrogate foreign corporations. The proposal would also expand the scope of an inversion to include certain asset acquisitions consisting of substantially all of a trade or business. The proposal clarifies that additional regulatory authority would be granted to exempt certain internal restructurings involving partnerships from the application of section 7874 and to define a trade or business for purposes of section 7874.

The Green Book's proposal would be effective for transactions that are completed after the date of enactment.

Disallow stock losses attributable to foreign income that was taxed at a reduced rate

In determining a U.S. shareholder's loss on the disposition of stock of a CFC, the proposal would require a U.S. shareholder to reduce its basis in the shares of a CFC (but not below zero) by the amount of deductions relating to GILTI or Section 965 income inclusions that were attributable to the stock.

Under current law, a U.S. shareholder is entitled to a dollar-for-dollar basis increase equal to the full amount of the subpart F or GILTI inclusion, notwithstanding the fact that the U.S. shareholder might have been entitled to a Section 250 or a Section 965 deduction as a result of that inclusion. The failure to take these deductions into account in determining the U.S. shareholder's basis in a CFC can cause a U.S. shareholder to recognize a loss that is arguably inappropriate.

For example, assume a U.S. shareholder realizes a GILTI inclusion of 100 with respect to a 100% directly owned CFC and claims a Section 250 deduction of 50 such that the U.S. shareholder has a net inclusion of 50, but under Section 961(a) the U.S. shareholder is entitled to a 100 basis increase in its CFC stock. If the U.S. shareholder thereafter disposes of the CFC stock for, say, 90, it would be entitled to claim a loss of 10, even though it had an income inclusions of only 50 (rather than 100). The proposal would require the U.S. shareholder to reduce its basis in the CFC stock by 10, from 100 to 90, which would eliminate the U.S. shareholder's loss with respect to the disposition of the CFC stock.

The proposal would also require basis adjustments with respect to stock or other property through which the U.S. shareholder owns the CFC stock (such, as for example, stock in another CFC), as well as stock or other property that has a basis determined with respect to the CFC stock.

The proposal would apply to dispositions occurring on or after the date of enactment regardless of whether the deduction under section 250 or 965(c) was claimed in tax years prior to such date.

KPMG observation

Existing Section 961(d) already requires basis reductions to eliminate losses with respect to a dividends-received reduction under Section 245A. This proposal would expand the Section 961(d) concept to eliminate losses with respect to deductions under Section 250 or Section 965(c). Like Section 961(d), it would eliminate losses, but it would not cause a reduction in gains. For example, if a U.S. shareholder realizes a GILTI inclusion of 100 with respect to a 100% directly owned CFC and claims a Section 250 deduction of 50, the U.S. shareholder would as described above be entitled to a full 100 basis increase under Section 961(a), notwithstanding that the U.S. shareholder had a net income inclusion of only 50. If the U.S. shareholder thereafter sells the stock for 120, it would not be required to reduce its basis and increase its gain recognized even though the recognized gain of 20

arguably understated its income inclusions by 50 (because the U.S. shareholder realized 120 on the disposition but reported net income inclusions of only 70 (100-50+20)).

Expand the definition of foreign business entity to include taxable units

The Green Book's proposed to expand information reporting for foreign business entities under section 6038 to each separate taxable unit of a corporation or partnership is substantially identical to the prior proposal in the FY 2023 Green Book. [Read **KPMG report: International tax proposals in Biden Administration's budget for FY 2023**]. This information reporting proposal substantially would align information reporting requirements with the substantive changes described above that determine CFC income and credits on a country-by-country basis.

Repeal BEAT and adopt the UTPR

The Green Book's proposal to repeal BEAT and adopt an undertaxed profits rule (as well as a domestic minimum top-up tax) is substantively identical to the same proposal in the FY 2023 Green Book (although the Green Book proposal would apply a UTPR global revenue threshold of €750 million rather than the $850 million threshold contained in the FY 2023 Green Book proposal). Although the proposal is substantively similar to last year's budget proposal, the 10-year revenue estimate for FY 2024 ($549 billion) is substantially larger than the proposal for the prior fiscal year ($239 billion). The UTPR proposal is intended to align the U.S. rules with the UTPR included in the OECD Pillar Two "global anti-base erosion" (GloBE) rules. Read KPMG's (March 28, 2022) report on the FY 2023 Green Book international tax proposals: [**KPMG report: International tax proposals in Biden Administration's budget for FY 2023**].

The Green Book's proposal would be effective for tax years beginning after December 31, 2024.

Repeal the deduction for FDII

The Green Book would repeal the deduction for foreign-derived intangible income (FDII), effective for tax years beginning after December 31, 2023. The proposal would redeploy the revenue raised by repealing FDII to directly incentivize research and development (R&D) in the United States but does not include a specific proposal for the enhanced R&D incentive. The Green Book's proposal is substantially similar to the proposal to repeal the deduction for FDII in the FY 2022 Green Book. [Read KPMG's May 31, 2021 report on the FY 2022 Green Book proposals: **KPMG report: Analysis and observations of tax proposals in Biden Administration's FY 2022 budget** [PDF 1.4 MB] (116 pages).]

Revise the rules that allocate subpart F income and GILTI between taxpayers to ensure that subpart F income and GILTI are fully taxed

The Green Book would modify the existing pro rata share rules for determining subpart F inclusions and GILTI inclusions for USSHs of CFCs. The proposal is substantially similar to a proposal in the House-approved BBBA, including the revised framework for determining a USSH's pro rata share for CFC shares directly or indirectly owned on the last relevant day and the new rules for CFC shares directly or indirectly owned during the year but not on the last relevant day. [Read a **KPMG report** [PDF 2.4 MB] (210 pages) dated November 19, 2021 that provides analysis and observations about the similar proposal in the House-approved BBBA.] The changes from the House-approved BBBA primarily relate to determining certain current year dividend amounts that would impact the pro rata share calculation and the Secretary's grants of authority. The changes include:

- The definition of "nontaxed current dividends" would be revised to (i) include dividends paid to a USSH that would qualify for a dividends received deduction, rather than only a section 245A(a) deduction; and (ii) provide authority for the Secretary to include dividends paid to upper-tier CFCs, rather than including dividends paid to upper-tier CFCs that are included in subpart F income as a result of the high-tax exception, same-country dividend exception, or the look-through rule of section 954(c)(6);
- The definition of pre-holding period dividends, which can reduce the pro rata share amount for shares directly or indirect owned by a USSH on the last relevant day, would be revised by adding authority for the Secretary to include dividends of current year earnings and profits paid to another CFC; and
- The Secretary's grant of authority would be expanded to include issuing guidance that: (i) treats distributions and other amounts as dividends or not as dividends; and (ii) requires (in addition to allowing) a foreign corporation to close its books upon a change in ownership for purposes of determining pro rata share.

The proposal would apply to tax years of foreign corporations that begin after the date of enactment, and tax years of USSHs that end with or within such year.

Eliminate exploited mismatch in calculation of earnings and profits of CFCs

The Green Book's proposal is substantively similar to the proposal in the BBBA to require CFCs to compute E&P for all purposes by taking into account LIFO, installment sales, and the completed contract method of accounting. [Read a KPMG report [PDF 2.4 MB] (210 pages) dated November 19, 2021 that provides analysis and observations about the similar proposal in the House-approved BBBA.] This change would generally align E&P determinations for CFCs more closely with E&P determinations for domestic corporations. While the BBBA proposed to strike section 952(c)(3) and add an equivalent rule, which requires that a CFC's E&P is computed without regard to section 312(n)(4), (5), and (6), to section 312(n), the Green Book does not specify how the change would be implemented.

In another notable contrast to the BBBA, the Green Book provision is proposed to be effective for tax years ending on or after December 31, 2023, rather than the date of enactment.

Limit foreign tax credits from sales of hybrid entities

The Green Book's proposal is substantively similar to the proposal in the BBBA that would extend the principles of section 338(h)(16) to a "covered asset disposition." In general, section 338(h)(16) applies to disregard the results of a section 338 deemed asset sale (which occurs when a section 338 election is made in connection with a qualified stock purchase) for purposes of determining the source and character of items in applying the foreign tax credit rules. A covered asset disposition is a direct or indirect disposition of an entity that is treated as a corporation for foreign tax purposes but as a partnership or disregarded entity for U.S. tax purposes and to entity classification changes that are not recognized for foreign tax purposes. Similar to existing section 338(h)(16), the proposal would limit taxpayers' control over the source and character of income generated in connection with a transaction that is an asset sale for federal income tax purposes [Read a KPMG report [PDF 2.4 MB] (210 pages) dated November 19, 2021 that provides analysis and observations about the similar proposal in the House-approved BBBA.]

Restrict deductions of excessive interest of members of financial reporting groups

The Green Book's proposal is similar to the House-passed BBBA proposal that limits disproportionate interest expense in the United States. [Read a KPMG report [PDF 2.4 MB] (210 pages) dated November 19, 2021 that provides analysis and observations about the similar proposal in the House-approved BBBA.] In general, the 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 in the United States compared to the rest of its worldwide group.

Unlike the BBBA proposal, and similar to the 2022 Green Book proposal, this year's proposal allows for excess limitation to be carried forward. The three-year carryforward limitation is new in this year's Green Book. The proposal also has a safe harbor that allows a group to apply section 163(j), substituting 10% for 30%. This approach also applies to a corporation that cannot substantiate its share of its financial reporting group interest limitation. [Read a **KPMG report: Analysis and observations of tax proposals in Biden Administration's FY 2022 budget** [PDF 1.4 MB] (116 pages).]

The Green Book's proposal would be effective for tax years beginning after December 31, 2023.

Treat payments substituting for partnership effectively connected income as U.S. source dividends

The Green Book proposal is similar to the proposal in the House-passed BBBA that imposes withholding tax on payments substituting for partnership effectively connected income (ECI). Read a November 2021 **KPMG report** [PDF 2.4 MB] (210 pages) on BBBA tax proposals in the House bill. The Green Book proposal contains less detail than the legislative text that passed the House of Representatives regarding the scope of derivative financial instruments covered and the payments subject to tax. In addition, the proposal may be narrower than the House-passed bill because it does not explicitly apply to gain on sale or exchange of a derivative financial instruments and is limited to payments determined by reference to partnership ECI (potentially excluding payments that refer to income taxable to a foreign partner other than ECI). Like the House-passed bill, the Greenbook proposal provides regulatory authority to carry out the purposes of the section.

The proposal would be effective tax years beginning after December 31, 2023.

Expand access to retroactive qualified electing fund elections

The Green Book proposal to permit a retroactive QEF election to the extent prescribed by the Secretary in regulations is substantively identical to the FY 2023 Green Book proposal. [Read KPMG's [May 31, 2022] report on the FY 2023 Green Book proposals: **KPMG report: Analysis and observations of tax proposals in Biden Administration's FY 2022 budget** [PDF 1.4 MB] (116 pages).]

For a detailed discussion of this proposal, see Kevin. M. Cunningham, Expanding Access to Retroactive QEFs: a Biden Proposal That Deserves a Swift Enactment, *Tax Notes International,* November 14, 2022, p.847.

The proposal would be effective on the date of enactment, and anticipates regulations or other guidance permitting taxpayer to amend previously filed returns for open years.

Reform taxation of foreign fossil fuel income

The Green Book's proposed changes with respect to foreign oil and gas extraction income and foreign oil related income, as well as proposed amendments to section 901(n) to codify the regulatory "dual capacity taxpayer" rules, are substantively identical to those proposed in the BBBA. [Read KPMG's September 16, 2021 report on the BBBA tax proposals: **KPMG report: "Build Back Better Act" tax proposals, as approved by Ways and Means** [PDF 2.3 MB] (203 pages).]

The Green Book's proposals would be effective for tax years beginning after December 31, 2023.

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

The Green Book's proposal to incentivize onshoring while eliminating tax deductions for offshoring is substantially similar to the proposal in the FY 2022 Green Book. [Read **KPMG report: Analysis and observations of tax proposals in Biden Administration's FY 2022 budget** [PDF 1.4 MB] (116 pages).] The proposal would create a new general business credit equal to 10% of eligible expenses paid or incurred in connection with onshoring a U.S. trade or business. The action must result in an increase in U.S. jobs. Eligible expenses incurred by a foreign affiliate of a U.S. taxpayer would result in a credit for the U.S. taxpayer.

The proposal would also disallow deductions for expenses paid or incurred in connection with offshoring a U.S. trade or business. The action must result in a loss of U.S. jobs. Further, no deduction would be allowed against a U.S. shareholder's GILTI or Subpart F income inclusions for any expenses paid or incurred in connection with moving a U.S. trade or business outside the United States.

Creditable expenses would be limited solely to expenses associated with the relocation of the trade or business and would not include capital expenditures or costs for severance pay and other assistance to displaced workers.

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

Housing and urban development

Make permanent the new markets tax credit (NMTC)

The administration's proposal would permanently extend the NMTC, with a new allocation for each year after 2025 of $5 billion, indexed for inflation after 2026.

The proposal would be effective after the date of enactment.

KPMG observation

The NMTC, which is currently extended until 2025, would be made permanent, providing greater certainty and planning opportunities for taxpayers who invest in NMTC projects located in economically underserved areas.

Provide a neighborhood homes credit

The administration's proposal would create a new allocated tax credit—the Neighborhood Homes Credit (NHC)—to encourage (a) new construction for sale, (b) substantial rehabilitation for sale, and (c) substantial rehabilitation by existing homeowners who will remain in their communities.

Allocation of NHCs

Each State would create a new agency (or designate a pre-existing agency) to serve as the Neighborhood Homes Credit Agency (NHCA) to allocate potential NHICs to project sponsors. Sponsors seeking potential NHCs would apply to their State NHCA which would choose the applications deemed best suited to

achieving the goals of the program. Each NHCA would be responsible for monitoring compliance with all provisions governing NHCs, for reporting violations to the Internal Revenue Service (IRS), and set standards developer fees, building quality, and development costs. NHCAs would be required to submit an annual report to the Secretary specifying the amount of potential NHCs allocated to each project for the previous year, information on each NHC residence completed in the previous year, and such other information as the Secretary may require.

Each State would have a specified amount of potential NHCs to allocate each year. For 2024 each State could allocate the greater of $8 million or the product of $6 times the State's population.

The amounts would be indexed for inflation for subsequent years, and States would be able to carry forward any unallocated potential NHCs for up to three years. Additionally, any NHCs allocated to a project that are unused after five years are returned to the pool of potential credits for the NHCA to re-allocate. These returned credits may also be carried forward for up to three years.

Project eligibility criteria

The homes being constructed or rehabilitated must meet the following criteria to be eligible for NHCs:

- The project must be a single-family home (including homes with up to four dwelling units), a condominium, or a residence in a housing cooperative.
- The project must be in an NHC neighborhood
- The project must be sold, or in the case of owner-rehabilitation projects completed, within five years of the allocation of the credit.
- After construction or rehabilitation, the home must be owned by an occupant who is a NHC qualified owner.

An NHC neighborhood is a low-income census tract that meets at one of three median income and median home value tests or is a census tract located in a disaster area.

A NHC qualified owner is someone who will use the home as their primary residence, whose household income does not exceed 140% of area/State median income, and in the case of a sale, is not related to the seller.

Determination of credit amount

The NHC amount generally would increase as development costs increase and decrease as sales proceeds (or owner payments, in the case of rehabilitation for current homeowners) increase. Construction costs are included in determining the NHC amount only to the extent they are incurred after a NHCA has allocated potential NHCs to the project, and acquisition costs for land and buildings are included to the extent they are incurred within three years prior of the allocation.

For home sales, the NHC would be limited to no more than 35% of the lesser of development costs and 80% of the national median sales price for new homes. The credit amount would phase out to zero as sales proceeds reach five times the area median family income, with an alternative phase out applying in the case of residences with more than one dwelling unit.

For the rehabilitation of an owner-occupied residence, the NHC would be limited to the lesser of $50,000 and 50% of rehabilitation costs.

Claiming the NHC and treatment of losses

A taxpayer could claim NHCs only after construction and inspection are completed and the home is occupied by a NHC qualified owner. If, within five years of the date of qualification for the NHC, the NHC qualified owner-occupant sells or rents the home, there may be NHC-related financial consequences to the

owner-occupant. In the case of a sale, up to 50% of the gain from the sale would have to be paid to the NHCA. In the case of renting, during the five-year period expenses with respect to renting would not be deductible against Federal income taxes.

If a taxpayer sells or rehabilitates a home for a loss, the NHC will not be considered compensation for that loss for purposes of determining whether the loss is deductible.

The Secretary and her delegates would be given authority to prescribe rules to implement this provision.

The proposal would be effective for tax years beginning after December 31, 2023.

KPMG observation

The NHC would provide a new federal tax credit that supports building or renovating owner-occupied housing. A proposal to set up a similar program was provided in the 2022 Greenbook and in the 2021 Build Back Better Act. The NHC would be allocated and administered under rules similar to the allocation and administration of the low-income housing credit.

Expand and enhance the low-income housing tax credit (LIHTC)

The administration's proposal to expand and enhance the Low-Income Housing Tax Credit (LIHTC) includes the following changes to the existing LIHTC program.

Increase the Annual HCDAs

The proposal would increase the annual housing credit dollar amounts (HCDAs). For 2024, each State would receive $4.25 per capita in new potential credits for allocation, subject to a minimum of $4,901,620 for smaller States. For 2025, the per capita and State minimum amounts would be $4.88 and $5,632,880, respectively. For 2026 and subsequent years, these amounts would be the amounts for the prior year, indexed for inflation as under current law.

Reduce the 50% PAB financing requirement

Currently, the 4% housing credit provides a credit from the State private activity bond (PAB) volume cap when 50% or more of the building and land is financed by tax-exempt bonds. The proposal would modify this requirement allowing a building to be eligible to earn LIHTCs on the basis of 25% (rather than 50%) PAB financing of the building and land.

This change would apply to buildings placed in service in tax years beginning after December 31, 2023.

Repeal the qualified contract provision

The proposal would eliminate the qualified contract exception for buildings receiving allocations after January 1, 2024.

Currently, the qualified contract exception allows an owner of a qualified low-income building to submit a written request beginning on the date after the 14th year in the compliance period, that the State housing credit agency (HCA) find a qualified buyer to acquire the owner's building within a one-year period from the date of such request. If the HCA is unable to find a qualified buyer, the building's extended use period terminates, and the housing affordability restrictions are removed.

Specifically, the repeal of the qualified contract provision would not apply to a building if, before January 1, 2024: (a) the building received an allocation of HCDAs, or (b) in the case of a building some portion of which is financed with PABs subject to volume cap, the building received a determination that the LIHTCs received on account of the PAB financing would be necessary for the building's financial feasibility and continued viability, and that an allocation of HCDAs would have been permissible in the absence of PAB financing.

In addition, for buildings that continue to be subject to the qualified contract provision, a qualified contract submitted after the date of enactment must have an offer purchase price that is the sum of the fair market value of the non-low-income and low-income portions of the building taking into account requirements under LIHTC rules.

The proposal to repeal the qualified contract provision would apply from the date of enactment.

Repeal the ROFR safe harbor and replace it with an option safe harbor

Under current law, no federal income tax benefit shall fail to be allowable to the taxpayer with respect to any qualified low-income building merely by reason of a right of first refusal held by the tenants (or a tenant group), a resident management corporation of such building, a qualified nonprofit organization, or a government agency to purchase the property after the close of the initial compliance period for a price which is not less than a certain purchase price. The proposal would modify this right of first refusal safe harbor into an option to buy safe harbor. Only persons that are eligible under current law to hold a right of first refusal could be the holder(s) of the option.

To be eligible for the safe harbor, the option right to purchase would have to cover both the building and assets required for continued operation as affordable rental housing and/or remaining partnership interests in the building. Additionally, the option right to purchase would have to be exercisable regardless of the approval or non-approval of the current owner or related persons.

Finally, upon exercise of the option, the purchase price of the qualified low-income building would have to be at least the amount of the debt securing the building that was incurred more than five years before the sale. The contractual purchase price of any partnership interest(s) would have to be at least the partner's ratable share of such debt.

The proposals would apply to agreements entered into, or amended, after the date of enactment. The proposal notes that the administration would work with Congress to develop an approach appropriate for existing agreements.

KPMG observation

The proposal would be a significant expansion of the LIHTC, increasing the amount of the current credit available to support and expand affordable housing. The proposal would also make it easier to qualify projects for the 4% credit by reducing the percentage of land and building required for the tax-exempt bond volume cap.

In addition, the proposal would repeal the qualified contract option thereby preserving the affordability of the low-income project rather than allowing the project to become market rate at the end of the initial compliance period. Replacing the ROFR safe harbor with the option safe harbor also works to help preserve the affordability of the low-income project by removing the ability to impose potential hurdles to the use of ROFRs.

Energy taxes

Eliminate fossil fuel tax preferences

Enhanced oil recovery credit

The administration's proposal would repeal the section 43 credit for enhanced oil recovery (EOR) costs for tax years beginning after December 31, 2023.

The general business credit includes a 15% credit for eligible costs attributable to EOR projects located in the United States involving the application of specified tertiary recovery methods. The allowable credit may be phased out for a tax year if the annual reference price of oil published by the Treasury exceeds an inflation adjusted statutory threshold price.

KPMG observation

For many years, higher oil prices caused the EOR credit to be completely phased out. However, as oil prices have fallen from peak levels, the EOR credit has been available in several recent years. For example, the EOR credit was available for calendar years 2016-2018 and 2021. While the credit was phased out for calendar years 2019, 2020, and 2022. If oil prices remain in line with 2022 prices, the repeal of the EOR credit would not impact taxpayers significantly. However, if oil prices decrease and stay low, the repeal of the EOR credit could have an impact.

Credit for oil and gas produced from marginal wells

The administration's proposal would repeal the section 45I credit for oil and gas produced from marginal wells for tax years beginning after December 31, 2023.

The general business credit includes a credit for crude oil and natural gas produced from marginal wells. The credit generally has served as an incentive to continue to operate wells, despite low production volumes or where the wells primarily produce heavy oil. However, the allowable credit may be phased out for a tax year if the reference price of oil published by the Treasury exceeds a statutory threshold price.

KPMG observation

The statutory threshold price for the marginal well credit is set at a low enough level that the credit has been subject to significant phase out in recent years. In 2021, the credit amount was the full rate of $0.67 per 1,000 cubic feet of natural gas and the credit for oil was completely phased out. As such, it is unlikely that the credit going forward would be a significant benefit, even if not repealed.

Expensing of domestic intangible drilling costs (IDCs)

The administration's proposal would repeal the section 263(c) deduction for IDCs for tax years beginning after December 31, 2023.

Section 263(c) and the regulations thereunder allow a deduction for all expenditures made by the holder of a working interest in a domestic oil and gas property for wages, fuel, repairs, hauling, supplies, and other expenses incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and natural gas. Generally, IDCs do not include expenses for items which have a salvage value or

items related to the acquisition of the property. The deductibility of IDCs under section 263(c) is elective, meaning that taxpayers have the option of choosing to capitalize IDCs instead, recovering them through depletion or depreciation. Moreover, a taxpayer who elects to deduct IDCs has the additional option in any tax year of electing under section 59(e) to deduct a portion of its IDCs and capitalize the rest.

KPMG observation

The deductibility of domestic IDCs is one of the oldest provisions in the tax system, dating back to 1916. It has been a key component of the oil and gas tax rules for a century, and its repeal would have a significant impact on oil and gas producers. The administration's proposal estimates that the repeal of the IDC deduction would generate approximately $10.5 billion in additional tax revenue between FY 2022 and FY 2031, making it the largest revenue raiser of the fossil fuels "tax preferences" that the administration proposes to repeal. However, simply repealing such a well-established provision without also providing for the expected treatment of those expenditures going forward leaves substantial uncertainty for taxpayers (and likely the IRS) to sort out. IDC is an umbrella term that covers several categories of expenditures, some of which may still be deductible (such as wages), may be capitalized to depreciable equipment (and possibly eligible for bonus depreciation), or may be capitalized to the depletable basis of the property. Moreover, the percentage of a taxpayer's IDCs falling into each category may vary greatly depending on the location of the reservoir, particularly when comparing on-shore and off-shore drilling.

Treasury may find that providing guidance that helps draw lines between those categories would reduce the burden of the repeal on examination teams.

What is also left unclear in the proposal is what the administration's plan is with respect to foreign IDCs, and whether the administration might choose to replace section 263(c) with a rule similar to the existing rule for foreign IDCs. Under section 263(i), IDCs paid or incurred with respect to wells located outside of the United States are not deductible. However, a taxpayer has the option of either capitalizing foreign IDCs into the depletable basis of the oil and gas property or amortizing the foreign IDCs over a 10-year period. Given that no changes were proposed with respect to section 263(i), it is possible that a similar amortization option could be provided for domestic IDCs, which would also have the benefit of providing certainty on the treatment of domestic IDCs going forward.

Deduction for costs paid or incurred for any tertiary injectant used as part of a tertiary recovery method

The administration's proposal would repeal the deduction under section 193 for costs paid or incurred for any tertiary injectant used as part of a tertiary recovery method for tax years beginning after December 31, 2023.

Section 193 provides that amounts paid or incurred for qualified tertiary injectants are deductible. Qualified tertiary injectants are used as a part of a tertiary recovery method to increase the recovery of crude oil, excluding any recoverable hydrocarbon injectants. The deduction may be subject to recapture upon a disposition of the property.

KPMG observation

The administration's proposal does not provide any guidance on the intended treatment of tertiary injectant expenditures following the possible repeal of section 193. Section 193 was enacted to clear up uncertainty as to the proper treatment of tertiary injectant expenditures, and it is hoped that further guidance would be provided if legislative text is eventually drafted. Specifically, query whether the cost of the tertiary injectants would be capitalized to the basis of the property and recoverable under cost depletion. Given the high cost of operating tertiary recovery projects, without a cost recovery

mechanism for injectant expenditures these projects may no longer be economically viable for many taxpayers.

Exception to passive loss limitations provided to working interests in oil and natural gas properties

The administration's proposal would repeal the exception under section 469(c)(3) to the passive loss limitation rules for working interests in oil and natural gas properties for tax years beginning after December 31, 2023.

Generally, section 469 denies taxpayers the ability to deduct losses from passive activities. When the taxpayer does not materially participate in a trade or business, section 469 requires losses from the business to be carried forward until the taxpayer has sufficient income from passive sources to offset them. However, section 469(c)(3) provides an exception to the general passive activity rules when a taxpayer holds a working interest in oil or gas property. Under section 469(c)(3)(A), the exception applies both where the taxpayer holds their share of the working interest directly and where the working interest is held through an entity such as a partnership (provided that the entity does not limit the taxpayer's liability with respect to the working interest). Therefore, as explained in section 469(c)(4), a taxpayer is not required to meet the material participation rules in the case of an investment in a working interest in oil or gas property. The administration's proposal would appear to treat an investment in a working interest in oil or gas property on par with other passive investments.

Percentage depletion with respect to oil and gas wells section 263A

The administration's proposal would repeal the use of percentage depletion with respect to oil and gas wells for tax years beginning after December 31, 2023.

The basis in oil and gas property is recovered through depletion. There are two methods for determining a taxpayer's depletion deduction for the tax year, with the taxpayer generally following the method which produces the larger depletion deduction for a given year. Cost depletion is determined by figuring out what percentage of the total recoverable reserves were recovered from the property during the tax year, with the taxpayer recovering a ratable portion of the tax basis in the property. In contrast, percentage depletion is a based on a percentage of the taxpayer's gross income realized from the property for the tax year. Because the calculation of the percentage depletion deduction is not a function of the taxpayer's remaining tax basis in the property, a taxpayer may be allowed to claim percentage depletion in excess of their tax basis in the property. If the administration's proposal were enacted, cost depletion would be the only method of determining a taxpayer's depletion deduction for oil and gas property.

KPMG observation

Percentage depletion on oil and gas property has been limited to independent producers and royalty owners since 1975. Presently, the independent producer and royalty owner exception is limited to taxpayers with a total share of production of 1,000 barrels of oil or natural gas equivalents per day for an individual, their spouse, and any minor children. Given the relatively low cap on a taxpayer's share of production in order to qualify for the independent producer exception, the administration's proposal is unlikely to have a meaningful impact on larger producers.

However, the elimination of percentage depletion may impact smaller outside investors in oil and gas properties, including those investing through funds, which have been an important source of capital for the industry. If the administration's proposal is adopted, the repeal of percentage depletion (along with many of the other oil and gas proposals discussed herein) could make the oil and gas sector a less attractive investment option and impact the ability to raise capital for future developments.

Geological and geophysical expenditures

Geological and geophysical expenditures are costs incurred for the purpose of obtaining and accumulating data that will serve as the basis for the acquisition and retention of mineral properties. The administration's proposal would repeal the two-year amortization of geological and geophysical expenditures under section 167(h) for independent producers, and replace it with the same seven-year amortization period currently used by major integrated oil and gas producers for tax years beginning after December 31, 2023.

KPMG observation

It is noteworthy that the administration chose to retain the favorable treatment afforded by section 167(h), albeit with the extended recovery period currently available to integrated producers, rather than simply repealing section 167(h) as they proposed with other oil and gas provisions. The enactment of section 167(h) was an attempt to settle an area of significant uncertainty and reduce the burden on examination teams. While section 167(h) has not eliminated all uncertainty in this area, it likely still provides sufficient value to taxpayers and government alike that the administration will be happy to have not proposed a repeal.

Expensing of mine exploration costs and development costs

The administration's proposal would repeal the election to deduct amounts paid or incurred for mine exploration under section 617 and mine development under section 616 for tax years beginning after December 31, 2023.

Under section 617 and section 616, a taxpayer is allowed a deduction both for the costs incurred in determining whether and where to mine an ore or mineral deposit as well as for the costs incurred in preparing the mine site for production. Under the existing law, if a taxpayer does not elect to deduct exploration and development costs, the amounts paid or incurred are capitalized to the basis of the mineral property and recovered through depletion. Presumably, if the administration's proposal were enacted, this would become the proper treatment of all exploration and development expenditures.

Percentage depletion for hard mineral fossil fuels

The administration's proposal would repeal percentage depletion for hard mineral fossil fuels for tax years beginning after December 31, 2023.

The basis in mineral property is recovered through depletion. There are two methods for determining a taxpayer's depletion deduction for the tax year, with the taxpayer generally following the method which produces the larger depletion deduction for a given year. Cost depletion is determined by figuring out what percentage of the total recoverable mineral reserves were recovered from the property during the tax year, with the taxpayer recovering a ratable portion of the tax basis in the property. In contrast, percentage depletion is based on a percentage of the taxpayer's gross income realized from the property for the tax year. Because the calculation of the percentage depletion deduction is not a function of the taxpayer's remaining tax basis in the property, a taxpayer may be allowed to claim percentage depletion in excess of their tax basis in the property. If the administration's proposal were enacted, cost depletion would be the only method of determining a taxpayer's depletion deduction for hard mineral property that produces what is considered a fossil fuel.

KPMG observation

The administration's proposal does not specify that it is intended to apply only to coal production. The introductory language to the section of the Green Book outlining the administration's fossil fuel

proposals lists oil, gas, and coal production as its intended subjects. However, the description of the proposal itself states that it is aimed at “coal mines and other hard-mineral fossil-fuel properties,” which raises the question of what other hard minerals are to be considered fossil fuels and would be covered by this proposal.

Capital gains treatment for royalties

The administration’s proposal would repeal capital gains treatment under section 631(c). for amounts realized in tax years beginning after December 31, 2023, from royalties received on the disposition of coal or lignite ore, regardless of when the property generating these royalties was acquired.

Under current section 631(c), a taxpayer who retains a royalty in connection with the disposal of coal (including lignite) or iron ore may treat the royalty payments as proceeds from the sale of the coal or iron ore. The result is that the royalty payments generate capital gain, rather than ordinary income. Moreover, despite being an economic interest in the coal or iron ore, the royalty income is not subject to depletion. Under the administration’s proposal, future royalty payments on sales of coal (including lignite) would appear to generate ordinary income instead of capital gain. The proposal does not appear to impact the current treatment under section 631(c) for retained iron ore royalties

KPMG observation

A retained royalty is an economic interest in the mineral, despite the treatment provided for by section 631(c). This raises the question of what the result would be if section 631(c) were repealed as proposed, but the administration was unsuccessful in repealing percentage depletion for coal. Does converting the section 631(c) retained royalty into a traditional economic interest then allow the taxpayer to take percentage depletion on the royalty income (assuming that all of the taxpayer’s tax basis in the property had been recovered already, such that cost depletion would be unavailable)?

Further, section 631(c) treats a retained royalty as more akin to an installment sale of the mineral property than as a traditional royalty. This treatment may leave several questions unanswered. For example, does a possible repeal of section 631(c) for coal (including lignite) open the door for taxpayers simply structuring their transactions aiming for installment sale treatment? Would exam teams be burdened with determining when a series of sales payments are properly viewed as a royalty?

Publicly traded partnerships

The administration’s proposal would repeal the exemption from the corporate income tax for publicly traded partnerships (PTPs) with qualifying income and gains from activities relating to fossil fuels. The repeal would not be effective until tax years beginning after December 31, 2028.

KPMG observation

PTPs generally are classified as corporations for tax purposes. However, section 7704 provides an exception for PTPs that derive at least 90% of their gross income either from industries that had traditionally organized as partnerships or from passive investment assets that the investors could have acquired directly. The natural resources extractive industries have been one of the activities which generate income that satisfies the 90% test, allowing natural resource PTPs to continue to qualify as passthrough entities under section 7704. In addition to the lack of a corporate-level tax on the business, investors in natural resources PTPs have benefitted from the flow through of depletion and depreciation deductions as an offset to their allocations of operating income. The public investors

have received reliable distributions of the cash generated by partnership operations, with relatively small allocations of net taxable income.

While several natural resources PTPs incorporated after the reduction in corporate rates, most have still found passthrough status to be an attractive way of raising capital for future acquisitions and development. If this proposal were enacted, particularly in combination with an increase in the corporate rates, query whether the natural resources PTP market itself might evaporate and whether many of the existing companies might find their operations no longer economically viable. However, with a proposed effective date five years in the future, the industry would have a long lead time to prepare.

Amortization of air pollution control facilities

The administration's proposal would expand the eligibility for accelerated amortization for air pollution control facilities for tax years beginning after December 31, 2023.

Section 169 provides for an 84-month recovery for certain pollution control facilities placed in service at coal-fired power plants after April 11, 2005. The administration's proposal intends to expand the eligibility under section 169 to cover new identifiable treatment facilities which are used, in connection with a plant or other property, to abate or control water or atmospheric pollution by removing, altering, disposing, storing, or preventing the creation or emission of pollutants, contaminants, wastes, or heat. The administration's concern is that, without an expansion of section 169 eligibility, these facilities would be subject to a 39-year recovery life.

Eliminate drawbacks on petroleum taxes that finance the Oil Spill Liability Trust Fund and Superfund

The administration's proposal would repeal the exemption from the section 4611 Oil Spill Liability Trust Fund excise tax for crude oil derived from bitumen and kerogen-rich rock for tax years beginning after December 31, 2023.

Section 4611 imposes an excise tax on crude oil and petroleum products to help fund the Oil Spill Liability Trust Fund. For purposes of section 4611, the definition of crude oil has been interpreted as excluding "synthetic" petroleum, such as oil produced from bituminous deposits or tar sands. The rate of tax on crude is the sum of the $0.09 per barrel financing rate dedicated to the OSLTF and the $0.164 per barrel financing rate dedicated to the Superfund. The administration's proposal would clarify that oil derived from bitumen and kerogen-rich rock is considered crude oil under section 4611, and therefore subject to the excise tax.

Impose digital asset mining energy excise tax

Current law does not impose an excise tax on digital asset mining energy use, although there are certain rules relating to broker reporting and reporting of cash transactions. Digital asset mining is a process for validating transactions among holders of digital assets to record and transfer cryptographically secured assets on a distributed ledger by, for example, using high-powered computers to perform calculations to select the validator. The computational effort involved in mining can be substantial and can therefore require a correspondingly large amount of energy. To address the increase in energy consumption attributable to the growth of digital asset mining and uncertainty and risks to local utilities and communities, the proposal would impose an excise tax on electricity usage by digital asset miners.

The proposal would impose an excise tax on any firm using computing resources, whether owned by the firm or leased from others, to mine digital assets. The excise tax would be equal to 30% of the costs of electricity used in digital asset mining. Firms engaged in digital asset mining would be required to report the amount and type of electricity used as well as the value of that electricity, if purchased externally. Firms

that lease computational capacity would be required to report the value of the electricity used by the lessor firm attributable to the leased capacity, which would serve as the tax base. Firms that produce or acquire power off-grid, for example by using the output of a particular electricity generating plant, would be subject to an excise tax equal to 30% of estimated electricity costs. For this purpose, except as otherwise provided by the Secretary, the term "digital asset" means any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary.

The proposal would be effective for tax years beginning after December 31, 2023. The excise tax would be phased in over three years at a rate of 10% in the first year, 20% in the second, and 30% thereafter.

KPMG observation

The proposal would, for the first time, impose an excise tax on energy consumption used by computing resources to mine digital assets equal to 30% of the costs of electricity used in digital asset mining. The proposal includes different tax computations, depending on whether the energy consumer is the purchaser or lessor, and whether the power is produced or acquired off-grid.

Taxation of high-income taxpayers

Increase the net investment income tax rate and additional Medicare tax rate for high-income taxpayers

Under current section 1411, a tax is imposed on net investment income (NII) in the case of certain individuals, estates, or trusts. In general, for individuals, the tax is 3.8% of the lesser of net investment income or the excess of modified adjusted gross income (AGI) over a threshold amount. The present threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case. The net investment income tax (NIIT) does not apply to self-employment earnings.

Also, under current rules, self-employment earnings and wages are subject to either the Self-Employment Contributions Act (SECA) tax or Federal Insurance Contributions Act (FICA) tax, respectively. Both SECA and FICA taxes apply at a rate of 12.4% for social security tax on earnings up to an indexed cap ($160,200 for 2023) and at a rate of 2.9% for Medicare tax on earnings (not subject to a cap). An additional 0.9% Medicare tax is imposed on self-employment earnings and wages of high-income taxpayers, bringing the combined rate of Medicare tax to 3.8% for these taxpayers.

The proposal would increase the NIIT rate by 1.2 percentage points for taxpayers with more than $400,000 of income, bringing the marginal NIIT rate to 5% for investment income above the threshold. This threshold would be indexed for inflation.

The proposal would also increase the additional Medicare tax rate by 1.2 percentage points for taxpayers with more than $400,000 of earning. When combined with current-law tax rates, this would bring the marginal Medicare tax rate up to 5% for earnings above the threshold. The threshold would likewise be indexed for inflation.

The two proposals above would be effective for tax years after December 31, 2022, and would require the revenue from these proposals to be directed to the Medicare trust fund (also known as the Hospital Insurance Trust Fund), instead of the general fund.

KPMG observation

A separate proposal in the Green Book (which has been proposed previously by the administration) would provide that a high-income individual would be subject to NIIT on net income or net gain regardless of whether the taxpayer materially participates in a trade or business that generated the net income or net gain, when such net income or net gain is not otherwise subject to the FICA or SECA regimes. The principal effect of this proposal would be to significantly expand the base of taxpayers who may be subject to the NIIT.

The two proposals referenced above have not been presented before by the administration. The proposals would have the effect of increasing the rate at which NII and Medicare income is taxed. When combined, the collective proposals impacting NIIT, and Medicare taxes are projected to generate additional revenue for the government of $650.3 billion (for the fiscal year periods from 2024-33).

Impose a minimum tax on the wealthiest taxpayers

The proposal would impose a minimum tax of 25% on total income (generally including unrealized capital gains) on taxpayers with "wealth" of more than $100 million. Payments of this minimum tax would be treated as a prepayment and thus available as a credit against subsequent taxes on capital gains to avoid double taxation of the same gain.

To implement this tax, taxpayers with wealth greater than the $100 million threshold would be required to report annually to the IRS the total basis and total estimated value, as of December 31 of each tax year, of their assets in each specified asset class, and the total amount of their liabilities. Based on this reporting, taxpayers who are illiquid may elect to include in the calculation of their minimum tax liability unrealized gain in only tradeable assets. However, making this election would subject the taxpayer to a deferral charge of up to 10% on the realization of the gains on any non-tradeable assets.

The proposal would be effective for tax years after December 31, 2023.

KPMG observation

This proposal is substantially similar to one previously proposed by the administration with the exception of the change in rate from 20% to 25%. This increase of 5% would result in a projected $75.8 billion in additional revenue for the government (for the fiscal year period from 2024-33), contributing to the overall proposed increase in the taxation of high-income taxpayers.

Retirement plans

Prevent excessive accumulations by high-income taxpayers in tax-favored retirement accounts and make other reforms

Special distribution rules for high-income taxpayers with large retirement account balances

The proposal requires distributions from retirement account balances in excess of $10 million for high income earners, who are individuals with adjusted taxable income in excess of $400,000, joint income of

$450,000, or $425,000 for head of household. All qualified retirement plans and eligible deferred compensation plans would be treated as one plan.

Accounts that exceed $10 million as of the last day of the preceding calendar year would be required to distribute a minimum of 50% of the excess. Further, accounts with greater than $20 million would be subject to a floor of the lesser of:

- That excess above $20 million, and
- The portion of the taxpayers' aggregate vested account balance that is held in a Roth IRA or designated Roth account.

Allocation of the distribution among plans would be at the discretion of the participant, but allocations subject to the floor must apply first to Roth amounts in Roth IRAs and then to Roth designated accounts.

Under the proposal, the distributions required are treated as an increase to the Required Minimum Distributions for purposes of the excise tax on failure to take RMDs. Excise tax for failure to take a distribution is 25%, but can be reduced to 10% if the failure is corrected within a specified period.

Under the proposal, an individual with $10 million in vested account balances could not make additional contributions to an IRA or such contribution is treated as an excess contribution subject to a 6% excise tax.

Under the proposal, such required distributions would not be eligible for rollover distribution treatment.

Section 72(t)(2) is proposed to be amended to except required distributions from the 10% additional tax on early distributions.

The proposal would require any increased minimum distributions from a qualified retirement plan, section 403(b) arrangement, or eligible deferred compensation plan to be subject to withholding at a 35% rate. Withholding would not be required from a designated Roth account.

A plan administrator would be required to report the vested account balance of any participant or beneficiary with a vested balance that exceeds $2.5 million. The report would separately report the vested balance held in a designated Roth account and the portion in other accounts.

These provisions are proposed to be effective for tax years beginning after December 31, 2023. However, the requirement that a plan administrator report vested account balance above $2.5 million would be effective for plan years beginning after December 31, 2023.

The combined proposals for excess retirement plans and limits for high earners are estimated to increase revenue by approximately $22.7 billion over the 10-year budget window.

KPMG observation

These provisions are very similar to the Mega-IRA proposals in the Build Back Better Act. Due to the $10 million threshold, the contribution and distribution requirements would not likely affect the majority of retirement plan participants.

Limit rollovers and conversions to designated Roth retirement accounts and Roth IRAs.

The proposal would prohibit high-income earners, who are individuals with adjusted taxable income in excess of $400,000, joint income of $450,000, or $425,000 for head of household, from rolling over or converting amounts held in a non-Roth designated account to a Roth account. The prohibition applies to

rollovers and distributions from an employer plan to a Roth IRA, as well as from conversions within an employer plan or from a non-Roth IRA to a Roth IRA.

This is proposed to be effective for tax years and distributions beginning after December 31, 2023.

KPMG observation

This proposal would eliminate the commonly used "backdoor" Roth conversion for all high-income earners. Backdoor conversions would still be allowed for taxpayers with income above the Roth IRA contribution limit, but below the high-income earner limit. However, this proposal does not appear to limit Roth contributions in employer retirement plans, but the conversion for amounts originally contributed pre-tax.

Prohibited transactions relating to holding DISC or FSC in individual retirement account

The U.S. tax system has had a series of special tax regimes intended to provide incentives for foreign trade, including domestic international sales corporations (DISC) and foreign sales corporations (FSC). The proposal would prohibit an IRA from holding an interest in a DISC or FSC that receives a payment from an entity, which is also owned by the IRA owner. Whether an entity is owned by the IRA owner is determined under the section 318 constructive ownership rules by the substituting 10% for 50%.

The sanction would be the same as the prohibited transaction sanction for an IRA owner (i.e., deemed to have distributed all assets on the first day of the tax year).

The proposal would be effective for interests in DISCs and FSCs acquired or held after December 31, 2023.

Statute of limitations with respect to IRA noncompliance

The proposal would extend the statute of limitations (SOL) from three to six years for additional tax assessments on prohibited transactions and erroneous information reporting relating to investment valuation in an IRA. This proposal is retroactive and would extend the SOL to six years for taxes with respect to which the three-year SOL ends (without regard to the amendment made by this proposal) after December 31, 2023. A similar proposal has been included in prior Green Books by the administration.

Workers, families, and economic security

Expand the child tax credit, and make permanent refundability and advanceability

The proposal would restore certain provisions from the ARPA such as increasing the maximum child tax credit (CTC) per child to $3,600 for qualifying children under age six and to $3,000 for all other qualifying children, increasing the maximum age to qualify for the child tax credit from 16 to 17 and making the credit fully refundable.

The proposal would also reform the CTC into monthly tax credits to be known as "monthly specified child allowances." Eligibility for and amount of the credit would be determined on a monthly basis. In determining eligibility for the credit, the proposal replaces the historical "qualifying child" eligibility standard with the "specified child" standard which focuses primarily on the source of care for the child. The proposal introduces the "presumptive eligibility" concept which determines when a taxpayer is eligible to claim the

monthly specified child allowance. During a period of presumptive eligibility, the proposal prohibits the child from being a specified child of any other taxpayer who has not established presumptive eligibility. The proposal also requires the Secretary to issue guidance for procedures to establish automatic presumptive eligibility and provide automatic grace periods for taxpayers who fail to establish presumptive eligibility in a timely manner to receive retroactive payments.

The proposal would require the Secretary to establish a program for making "monthly advance child payments" to be disbursed electronically. A monthly advance child payment would be equal to the taxpayer's monthly specified child allowance. The annual total of specified child allowances to which a taxpayer is entitled would be compared with the annual total of advance child payments received on the taxpayer's federal income tax return. Taxpayers could claim an additional credit if they had not received the total specified child allowances that they were entitled to and would be required to make a repayment if they had received more than they should have.

Additional proposed changes include an online portal to facilitate sharing of information between taxpayers and the IRS, streamlined processes to address claims by multiple taxpayers for the same specified child and rules to address potential abuses.

The proposed changes to the maximum credit amounts, phase-out thresholds, age requirements and refundability would be effective for all tax years beginning after December 31, 2022 and, except for refundability, would expire for tax years beginning after December 31, 2025. The proposed changes related to the implementation of the advance monthly payment program would be effective for all tax years beginning after December 31, 2023.

KPMG observation

While many elements of the proposal have previously been presented before by the administration, this proposal introduces the concepts of "specified child" and "presumptive eligibility." The care-based approach to eligibility may align better with the changing aspects of today's modern families. The system of presumptive eligibility should help to reduce mistakes or inconsistencies in taxpayer reporting, such as multiple taxpayers claiming the same child, and assist the IRS in administering the law.

Higher-income taxpayers may not qualify for the increased amounts of the credit but would potentially still qualify for the lower pre-ARPA amounts.

Restore and make permanent the American Rescue Plan expansion of the earned income tax credit (EITC) for workers without qualifying children

The earned income tax credit (EITC) is a refundable credit intended to support low- to moderate-income working families. The EITC is based on a worker's family size, filing status, adjusted gross income and earned income. The ARPA made a number of temporary changes to the EITC for workers without qualifying children including lowering the minimum age for eligibility, eliminating the maximum age limit for eligibility and increasing the income thresholds. This proposal would restore for 2023 and make permanent the increases in the EITC provisions enacted by the ARPA. The proposal would be effective for tax years beginning after December 31, 2022.

KPMG observation

The proposal was previously presented by the administration.

The proposal is intended to allow more workers without children to qualify for the EITC by increasing the income thresholds and expanding the age range for eligibility.

Make permanent the Inflation Reduction Act expansion of health insurance premium tax credits

The premium tax credit ("PTC") is provided to certain individuals who purchase health insurance through a marketplace exchange under the Affordable Care Act of 2010. The PTC is a refundable credit and may be payable in advance directly to the insurer. Eligibility for advance payments of the PTC is based on the household income and family size. A taxpayer's PTC is equal to the lesser of the amount of their health insurance premium or the amount by which a benchmark plan premium exceeds the taxpayer's "required contribution" (i.e., a percentage of household income). The ARPA decreased the percentages used to calculate the required contribution and extended PTC eligibility to taxpayers with household income above 400% of the federal poverty line for tax years 2021 and 2022. The Inflation Reduction Act of 2022 (IRA) extended the ARPA changes through tax year 2025. Prior to ARPA, the required contribution percentages were indexed for inflation but fixing those percentages through 2025 effectively paused the indexation.

The proposal would make the ARPA and IRA decrease in the percentages used to calculate the required contribution permanent and permanently repeal the indexation of those percentages. In addition, the proposal would make permanent the extended PTC eligibility to taxpayers with household income above 400% of the federal poverty line. The proposal would be effective for tax years beginning after December 31, 2025.

KPMG observation

The proposals to reduce the percentage of annual income that households are required to contribute toward the premium and extend eligibility for the credit to taxpayers with household income above 400% of the federal poverty line have been previously presented by the administration. In addition, one previous proposal provided that the applicable contribution percentages would not be indexed until 2027 but under the current proposal, the indexing would be permanently repealed.

The proposal is intended to allow more taxpayers to qualify for the PTC thus reducing the cost of health insurance coverage for a wider range of income levels.

Make the adoption tax credit refundable and allow certain guardianship arrangements to qualify

The proposal would make the adoption credit fully refundable. Under current law, taxpayers who claim an adoption credit but do not have sufficient tax liability to benefit from the full amount of the credit are able to carry the credit amount forward up to five years. Any portion of the adoption credit carryforward that cannot be used in those five years would expire unused. Under this proposal, taxpayers who have unexpired adoption credit carryforwards would be able to claim the full amount of those carryforwards on their 2024 returns. Unused carryforwards that expired prior to 2024 would not be eligible to be claimed.

The proposal also allows families who enter into a guardianship arrangement with a child that meets certain requirements to claim a refundable credit for the expenses related to establishing the guardianship relationship. In order for a guardianship arrangement to be eligible for this credit: 1) the relationship must be established by court order, 2) the arrangement must not be with the guardian's own child or stepchild, 3) the guardian and the child must meet a residency requirement and 4) the child must be under age 18 at the time the relationship is established. If the child is later adopted by the guardian, expenses eligible for the adoption credit would be reduced by any guardianship expenses already claimed.

The proposal would be effective for tax years beginning after December 31, 2023.

KPMG observation

This proposal has previously been presented by the administration.

Low- and moderate-income families may not have sufficient tax liability to utilize the full amount of an adoption credit so often families that could use this benefit the most are losing some or all of the benefit. If the adoption credit is made refundable, the tax benefit will be guaranteed. The tax benefit lowers the cost of an adoption, potentially making adoptions attainable for more families.

In some cases, a family may wish to assume legal and financial responsibility for a child through a guardianship rather than an adoption. The credit for expenses related to guardianships is intended to offset the cost of establishing the guardianship and may provide more families with the financial ability to provide for children in need.

Make permanent the income exclusion for forgiven student debt

The ARPA provided an exception to the treatment of forgiven loan amounts as gross income for certain qualifying student debt that is discharged after December 31, 2020, and before January 1, 2026. The proposal would make this exception permanent. The types of student loans that are eligible for the exclusion include loans made expressly for post-secondary education expenses if the loan was made, insured or guaranteed by a federal, state or local government entity or eligible educational institution; private education loans; and certain loans made by educational and tax-exempt organizations. The proposal would be effective for tax years beginning after December 31, 2025.

KPMG observation

A previous version of this proposal was presented by the administration to be effective on the date of enactment.

Prior to the ARPA, many types of federal student loan forgiveness were already excluded from gross income. The expansion of the types of student debt that will qualify for income exclusion when forgiven is intended to provide more consistency in the treatment of debt forgiveness.

Extend tax-preferred treatment to certain federal and tribal scholarship and education loan programs

Gross income generally does not include certain scholarship amounts that are used to pay tuition, required fees and related expenses such as books, computers, etc. Scholarship amounts that are used to pay other expenses, such as childcare and travel, or that represent payment for services, such as teaching or research or other services that are required as a condition for receiving the scholarship, are considered ordinary income and are taxable. Individuals who receive scholarships for services from certain organizations that provide care or assistance to underserved populations are not taxed on those scholarships. The proposal would extend this preferred tax treatment to other federal and tribal organizations that also provide care or assistance to underserved populations but are not currently included within the exception.

Loan amounts that are repaid on behalf of another individual are considered ordinary income and are taxable unless excepted. Debt that is repaid under certain programs intended to increase the availability of heath care services in underserved areas and certain work-related loan forgiveness programs are among the exceptions. The proposal would extend this preferred tax treatment to additional loan repayment programs similar to the ones currently receiving the favorable treatment.

The proposal would also provide that Segal AmeriCorps Education Awards that are used for current education expenses would be treated like scholarships even though the awards represent payment for services. Awards used to repay student loans or transferred awards would also be excluded.

The proposal would extend the preferred tax treatment to these federal and tribal organizations by adding the names of their programs to the exceptions listed. The proposal would be effective for tax years beginning after December 31, 2023.

KPMG observation

There are several federal and tribal loan repayment and scholarship programs that are similar to the programs listed as an exception but do not currently receive such preferred tax treatment. As a result, participants in similar programs may be receiving very different tax treatment with respect to scholarships and loan forgiveness. By adding these programs as exceptions, the participants in programs with very similar purposes will be treated similarly.

Segal AmeriCorps Education Awards may only be used for education purposes – either for current expenses or loan repayment. Since these awards are similar to scholarships and loan repayment programs that receive preferred tax treatment, recipients of these awards should be able to benefit from the same tax treatment.

Increase the employer-provided childcare tax credit for businesses

The proposal would increase the section 45F credit for qualified child care expenses from 25% to 50% and increase the accompanying maximum credit limitation from $150,000 to $500,000. The credit related to referral expenses would remain at 10% with a maximum amount of $150,000. The section 45F credit generally applies to amounts paid or incurred for the operating costs or under a contract with a qualified child care facility or to acquire, construct, rehabilitate, or expand property which is to be used as part of a qualified child care facility by the taxpayer.

The proposal is effective for tax years beginning after December 31, 2023.

The JCT has estimated that the proposal will decrease revenues by $358 million over 10 years.

KPMG observation

Prior proposals have included similar increases in credit, but for a temporary two-year period.

Improve the design of the work opportunity tax credit (WOTC)

The administration included a new proposal in this year's Green Book to improve the design of the WOTC to promote longer-term employment. This proposed change would be effective for individuals hired after December 31, 2023.

The work opportunity tax credit (WOTC) is currently available for employers who are hiring individuals from one or more of 10 targeted groups and is generally equal to 40% of qualified wages paid during the first year of employment (i.e., first-year wages). The WOTC does not presently apply to wages paid to individuals who work fewer than 120 hours in the first year of service and is reduced to 25% if the individual works at least 120 hours, but less than 400 hours.

The allowance of the reduced 25% credit may encourage the hiring of temporary employees, contrary to the goal of WOTC of providing long-term employment opportunities to members of targeted groups. Accordingly, the proposal would increase the minimum number of hours worked by an individual in the first year of service to become eligible for the WOTC from 120 hours to 400 hours, thus eliminating the 25% credit for employees who work between 120 and 400 hours.

Estate and gift taxation

Improve tax administration for trusts and decedents' estates

Expand definition of executor

The current statutory definition of "executor" only applies for estate tax purposes. This can cause various administrative issues because there may be no one who can represent the estate with respect to income tax liabilities and reporting obligations, or there may be multiple individuals who meet the definition. This proposal would move the existing definition of executor from section 2203 to section 7701, expressly making it applicable for all tax purposes, and would authorize such an executor to do anything on behalf of the decedent in connection with the decedent's pre-death tax liabilities or other tax obligations that the decedent could have done if still living. The proposal also would grant regulatory authority to the Secretary to adopt rules to resolve conflicts among multiple executors authorized by that provision. The proposal would apply upon enactment, regardless of a decedent's date of death. This proposal is substantially similar to the proposal included in last year's Green Book.

Increase the limit on reduction in value of special use property

As a general rule, the value of property included in a decedent's estate for estate tax purposes is its "fair market value." Section 2032A allows the estate to elect to value certain real property used in farming or other trades or businesses at its current use (rather than other more valuable uses the property might be put to in the hands of a willing buyer). Under current law, the allowed valuation reduction (attributable to value at current use) is limited to $750,000 (or $1,310,000, as adjusted for inflation to 2023). The proposal would increase the permitted valuation reduction to a maximum of $13,000,000. This provision would be effective for estates of decedents dying on or after the date of enactment. This proposal is substantially similar to the proposal included in last year's Green Book and the House Ways and Means Committee recommendations for the Build Back Better Act.

KPMG observation

Opponents of the estate tax often express concern that it may require farmers and small business owners to sell the business or farm in order to pay the estate tax. This can be even more of an issue when the "highest and best use" of real property owned by the decedent (or his business) may be in developing it rather than using it for its current use as a farm or otherwise such that the estate tax value significantly exceeds its special use value. This proposal enhances the estate tax benefits of section 2032A for this group of taxpayers and appears to be a relief measure for farmers and small business owners.

Extend 10-year duration for certain estate and gift tax liens

Current law provides for an automatic 10-year lien on all gifts made by a donor and generally on all property in a decedent's estate to enforce the collection of gift and estate tax liabilities from the donor or the decedent's estate, as applicable. This lien cannot be extended, even where the IRS allows the tax to be paid over a timeframe that extends beyond 10 years. The proposal would extend the duration of the automatic lien beyond the current 10-year period to continue during any deferral or installment period for unpaid estate and gift taxes. The proposal would apply to 10-year liens already in effect on the date of enactment, as well as to the automatic lien on gifts made and the estates of decedents dying on or after the date of enactment. This proposal is substantially similar to the proposal included in last year's Green Book.

Require reporting of estimated total value of trust assets and other information about the trust

As originally included in the Biden Administration's FY 2023 Green Book, this proposal would require certain trusts to report certain information to the IRS on an annual basis, including the name, address, and TIN of each trustee and grantor of the trust, and general information with regard to the nature and estimated total value of the trust's assets. This reporting requirement would apply to each trust whose estimated total value on the last day of the tax year exceeds $300,000 (indexed for inflation) or whose gross income for the tax year exceeds $10,000 (indexed for inflation).

The Biden Administration's FY 2024 Green Book proposals would also require trusts (in this case, regardless of value or income) to report the inclusion ratio of the trust for generation-skipping transfer (GST) tax purposes at the time of any distribution to a non-skip person as well as information regarding any trust modification or transaction with another trust. This information would allow the IRS and the taxpayer to verify the GST tax effect of contributions to and distributions from the trust without requiring a review of multiple years' records to determine that information. The proposal would apply for tax years ending after date of enactment.

KPMG observation

It is unclear what specific concern the addition to the FY 2023 proposal relating to GST tax is intended to address. One possibility is that it relates to the new proposal (described below) requiring redetermination of a trust's inclusion ratio when the trust purchases assets from, or an interest in, another trust. The reporting of the inclusion ratio at the time of a distribution to a non-skip person is curious given that distributions to non-skip persons are not subject to GST tax and do not impact the trust's inclusion ratio. Perhaps part of the focus is on the potential loss of exempt status due to a trust modification or decanting. Or perhaps this is merely a way to encourage contemporaneous tracking of changes to the trust's inclusion ratio caused by additional contributions given the long history associated with many trusts today.

Require that a defined value formula clause be based on a variable that does not require IRS involvement

When gifting or selling hard-to-value assets (such as interests in a closely held business) taxpayers are often concerned about unanticipated gift tax exposure where the assumed value at the time of transfer ends up being lower than the value that is ultimately determined by the IRS and the courts. For example, the donor may want to utilize his/her lifetime gift tax exemption ($12,920,000 for 2023), but not pay gift tax on any overage. Formula clauses have become increasingly popular in recent years as a way for taxpayers to avoid this risk of unanticipated gift tax exposure. These formula clauses take different forms but typically

limit any potentially taxable gift to a certain defined value/dollar amount (e.g., the number of units equal in value to $X) “as finally determined for federal gift tax purposes”.

The proposal would provide that if a gift or bequest uses a defined value formula clause that determines value based on the result of involvement of the IRS (which would seem to cover situations where the formula uses the “as finally determined for federal gift tax purposes” verbiage), then the value of such gift or bequest will be deemed to be the value as reported on the corresponding gift or estate tax return. On the other hand, the formula clause would be effective if the unknown value is determinable by an appraisal that occurs within a reasonably short period of time after the transfer, or the clause is used to define a marital or exemption equivalent bequest at death. The proposal would apply to transfers by gift or on death occurring after December 31, 2023.

KPMG observation

The IRS has argued that formula clauses should not be respected, in part because they make examination of the gift tax return and litigation by the IRS cost-ineffective. However, the courts have been more receptive to formula clauses and taxpayers have prevailed in a number of cases. If enacted, this proposal would appear to make formula clauses (at least the most popular and effective variety described above) void.

KPMG observation

The effective date for this proposal is December 31, 2023, instead of the more typical “date of enactment”. If the proposal were enacted before the indicated date, there might be a window of opportunity for taxpayers to make effective formula clause gifts prior to the end of the calendar year.

Simplify the exclusion from the gift tax for annual gifts

The gift tax does not apply to the first $17,000 of present interest gifts made to each donee (during 2023). As a contribution to a trust for the benefit of a donee does not normally meet the present interest requirement, taxpayers often give the trust beneficiaries rights to withdraw their share of the contribution for some limited period of time (known as “Crummey powers”); if timely notice of the right to withdraw is provided to the beneficiaries, the annual exclusion may then become available. Although there are clearly benefits to using Crummey powers and many trusts incorporate them, ensuring their effectiveness adds administrative complexity. In addition, Crummey powers are often granted primarily to avoid gift tax rather than with an intent that the beneficiary actually exercises their right to withdraw a contribution.

The proposal would eliminate the gift tax annual exclusion’s present interest requirement with respect to certain gifts. It would create a new category of transfers including transfers in trust, transfers of interests in passthrough entities, transfers of interests subject to a prohibition on sale, and other transfers of property that, without regard to withdrawal, put, or other such rights in the donee, cannot immediately be liquidated by the donee. The proposal would impose an annual limit per donor of $50,000 (indexed for inflation) on transfers of property within this new category that will qualify for the annual exclusion. This proposal is substantially similar to the provision included in the Obama Administration’s FY 2016 Green Book. The proposal would be effective for gifts made after December 31, 2023.

KPMG observation

It is unclear how the overlap between the current annual exclusion of $17,000 per donee and this new annual exclusion of $50,000 will operate. The proposal seems to eliminate the benefits of using *Crummey* powers to secure the annual exclusion for transfers in trust. Under the proposal, transfers

in trust need not qualify as gifts of a present interest but such transfers will only be excludable from the reach of the gift tax up to a maximum of $50,000 in value regardless of how many beneficiaries the trust has. This $50,000 limit would also apply to gifts of interests in passthrough entities (even where such gifts are made outright rather than in trust and regardless of how many donees are involved). However, the proposal appears to continue to allow for the exclusion from gift tax for outright gifts of cash and other liquid assets up to the current $17,000 per donee limit.

Limit duration of generation-skipping transfer tax exemption

GST tax is imposed on gifts and bequests to transferees who are two or more generations younger than the transferor (e.g., the transferor's grandchildren). Each person has a GST exemption ($12.92 million for 2023) that can be allocated to transfers made to such "skip persons", whether outright or in trust. The allocation of GST exemption to a transfer excludes from the GST tax not only the amount of the assets equal to the exemption allocated, but also all appreciation and income on that amount. Many states have repealed limitations on the duration of trusts and now allow them to continue in perpetuity, resulting in an expansion of the transfer tax shield provided by the GST exemption.

The proposal would provide that the GST exemption would apply only to: (a) direct skips and taxable distributions to beneficiaries no more than two generations below the transferor, and to younger generation beneficiaries who were alive at the creation of the trust; and (b) taxable terminations occurring while any person described in (a) is a beneficiary of the trust. Solely for purposes of determining the duration of the exemption, a pre-enactment trust would be deemed to have been created on the date of enactment and, in this case, the proposal would provide that the grantor is deemed to be the transferor and in the generation immediately above the oldest generation of trust beneficiaries in existence on the date of enactment. Specifically, this limit on the duration of the GST exemption would be achieved at the appropriate time by increasing the inclusion ratio of the trust to one, thereby rendering no part of the trust exempt from GST tax.

The proposal would apply on and after the date of enactment to all trusts subject to the generation-skipping transfer tax, regardless of the trust's inclusion ratio on the date of enactment. This proposal is substantially similar to the proposal included in last year's Green Book.

KPMG observation

This proposal would potentially reduce the transfer tax benefits of creating very long-term or perpetual trusts as such trusts would only be shielded from transfer tax for a more limited period of time than under current law. However, for donors with great-grandchildren (or even young grandchildren) alive, a trust for their benefit could still exist and be exempt from transfer taxes for a significant period of time. In addition, there could be other non-transfer tax benefits to such perpetual trusts—for example, asset protection, income tax savings, or professional asset management.

Modify income, estate, gift, and generation-skipping transfer tax rules for certain trusts

Modify tax rules for grantor trusts

The following three proposals relating to GRATs specifically and grantor trusts more generally are substantially similar to the proposals included in last year's Green Book.

Grantor retained annuity trusts

A grantor retained annuity trust (GRAT) pays the grantor an annuity each year, and any remaining assets in the trust at the end of the annuity term pass to the remainder beneficiaries (typically, the creator's children). If the grantor retains a sufficiently large annuity payment during the term—equal in value to the assets originally transferred to the GRAT plus the required assumed rate of return— the value of the remainder gift can be "zeroed out," such that no taxable gift is made. If the grantor survives the term and the assets in the trust outperform the assumed rate of return, the excess passes to the beneficiaries free of gift tax. However, if the grantor dies during the term, the assets are included in the grantor's estate for estate tax purposes, and the GRAT's benefit (the tax-free transfer of appreciation on the assets in excess of the annuity payments) is not realized. Taxpayers have become adept at maximizing the benefit of the GRAT by minimizing the term (and reducing the risk that the grantor will die during the term) and by retaining annuity interests significant enough to reduce the gift tax value of the remainder interest to zero.

The proposal would require, in effect, some downside risk in the use of this technique by imposing the requirement that a GRAT have a minimum term of 10 years and a maximum term of the life expectancy of the annuitant plus 10 years. The proposal also would include a requirement that the remainder interest have a value equal to the greater of 25% of the value of the assets transferred to the GRAT or $500,000 and would prohibit any decrease in the annuity during the GRAT term. This would increase the risk that the grantor fails to outlive the GRAT term and the resulting loss of any anticipated transfer tax benefit. The proposal would apply to all GRATs created on or after the date of enactment.

Transfers for consideration between a grantor trust and its grantor-owner

Generally, a trust is treated as a grantor trust if the grantor retains certain powers over or benefits in the trust. A deemed owner of a grantor trust is treated as owning the assets of the trust solely for income tax purposes. As a result, sales and other transactions between a grantor trust and its grantor-owner are disregarded for income tax purposes and generate no capital gain.

The proposal would treat the transfer of an asset for consideration between a grantor trust (other than a revocable trust) and its grantor-owner as one that is regarded for income tax purposes, which would result in the seller recognizing gain on any appreciation in the transferred asset and the buyer owning the asset with a basis equal to the value of the asset at the time of the transfer. Such regarded transfers would include sales as well as the satisfaction of an obligation (such as an annuity or unitrust payment) with appreciated property. The proposal would also add these transactions to those for which losses are disallowed under section 267(b). The gain recognition portion of the proposal would apply to all transactions between a grantor trust and its grantor-owner occurring on or after the date of enactment. A similar proposal was included in the House Ways and Means Committee recommendations for the Build Back Better Act.

Payment by grantor of income tax on grantor trust's income

The income tax liability attributable to a grantor trust's assets is the obligation of the grantor-owner, rather than the obligation of the trust or its beneficiaries. No amount paid by the deemed owner of a grantor trust to satisfy the trust's income tax liability is treated as a gift by the owner to the trust or its beneficiaries for Federal gift tax purposes.

The proposal would provide that the payment of the income tax on the income of a grantor trust is a gift on December 31 of the year in which the income tax is paid unless the grantor-owner is reimbursed by the trust during the same year. The amount of the gift cannot be reduced by a marital or charitable deduction or by the annual gift tax exclusion. The proposal characterizing the grantor's payment of income taxes as a gift would apply to all trusts created on or after the date of enactment.

KPMG observation

The tax rules regarding what qualifies as a completed transfer for income tax purposes and for estate tax purposes are not identical. Because of these differences, an irrevocable trust can be structured so its assets are excluded from the grantor's estate (and considered completed gifts) but its income is taxed to the grantor (as if the gift had not been made). A trust known as an intentionally defective grantor trust takes advantage of these differences, allowing the trust assets to grow undiminished by income tax (because the tax liability associated with such growth is paid by the grantor of the trust rather than the trust itself) for the benefit of future generations while also removing growth on assets gifted or sold to the trust from your estate for estate tax purposes. As discussed above, a trust that is treated as not separate from the grantor for income tax purposes has another advantage - sales of appreciated assets by the grantor to the trust are ignored for income tax purposes and generate no capital gain. Nor does a sale to the trust result in gift tax liability, as the transfer of additional assets to the trust is for full and adequate consideration. The prior two proposals appear to be directed at substantially reducing the benefits of this estate freeze technique.

KPMG observation

The proposal that would regard sales between a grantor-trust and its grantor-owner would also appear to prevent the grantor from making tax-free purchases of appreciated assets owned by the trust prior to death. This technique is sometimes utilized so that the appreciated assets are owned in the grantor's individual name at death and accorded a step-up in basis. If this proposal were enacted, a tax-free purchase could no longer be achieved.

Adjust a trust's GST inclusion ratio on transactions with other trusts

The GST tax is imposed on generation-skipping transfers from a trust at a rate equal to the product of highest estate tax rate (currently 40%) and the trust's inclusion ratio. A trust's inclusion ratio is the fraction of the trust that is not exempt from GST tax. (For example, if the trust has an inclusion ratio of 0, then the trust is completely exempt.) This ratio must be redetermined at certain times, including each time an additional contribution is made to the trust (whether by a donor or through the consolidation of two trusts) and each time additional GST exemption is allocated to the trust. On the other hand, there is no need to redetermine the inclusion ratio if assets are purchased by a trust for full and adequate consideration as this is just a reinvestment of trust assets rather than an additional contribution.

The proposal would treat a trust's purchase of assets from, or interests in, a trust that is subject to GST tax (regardless of the selling trust's inclusion ratio), as well as a purchase of any other property that is subject to GST tax, as a change in principal which would require the redetermination of the purchasing trust's inclusion ratio. If the selling trust is not completely exempt from GST tax, this could have the effect of diluting the purchasing trust's exempt status. The proposal would apply to all such transactions occurring after the date of enactment.

KPMG example

Assume a trust has $10M in assets and an inclusion ratio of zero (i.e., the trust is fully exempt from GST tax). The trust then buys $1 million in assets from a non-exempt trust (i.e., a trust with an inclusion ratio of 1) for $1 million in cash. This purchase of non-exempt assets would dilute the trust's exempt status and result in a new inclusion ratio of 10%. As a result, unless additional GST exemption was allocated to the trust, GST tax would be due at the time of any generation-skipping transfers.

KPMG observation

Some taxpayers have taken the position that a GST exempt trust can purchase the remainder interest in a non-exempt zeroed-out GRAT (where the value of the remainder interest after the grantor's retained annuity is worth next to nothing), and then, at the end of the GRAT term, when the GRAT assets are paid over to the exempt trust, there is no change to the exempt trust's inclusion ratio. In essence, according to the Green Book, the purchase by the GST exempt trust "cleanses the purchased interest of its GST potential". It is unclear how the proposal would apply in this scenario. Redetermining the inclusion ratio by adding the de minimis value of the purchased remainder interest would not seem to dilute the exempt status of the purchasing trust in a significant way. Perhaps the proposal would redetermine the inclusion ratio instead by adding the value of the assets owned by the GRAT either at the time of the remainder purchase or at the end of the GRAT annuity term.

Change the GST tax characterization of certain tax-exempt organizations

The GST tax may be imposed on a termination of an interest in a trust (e.g., resulting from the death of a beneficiary) unless a non-skip person (a term which includes a tax-exempt organization) still has an interest in the trust. Although interests held by most charitable tax-exempt organizations are ignored under current law, interests held by other non-charitable tax-exempt organizations are taken into account. As a result, naming one of these non-charitable tax-exempt organizations as a potential recipient of trust distributions is enough to avoid the imposition of GST tax on the trust, even though that organization may be unlikely to ever receive a distribution from the trust.

The proposal would ignore trust interests held by non-charitable tax-exempt organizations – specifically, organizations described in section 501(c)(4) through (29) (other than (10)) (e.g., social welfare organizations, business leagues, social clubs, and veterans' organizations)—such that inclusion of these organizations as permissible beneficiaries of the trust would not prevent the occurrence of a taxable termination. The proposal would apply in all tax years beginning after the date of enactment.

Modify the definition of a guaranteed annuity from a charitable lead trust (CLAT)

CLATs are often used to minimize transfer tax while benefitting both charity and family members. A charity chosen by the donor must receive annuity payments for a certain number of years and the remaindermen (typically, the donor's children) will receive the corpus at the end of the trust term. If the value of the income interest given to charity is significant enough, the gift to the children will be de minimis (or even "zeroed-out") and any gift tax exemption used or gift tax paid will be minimized. If the trust assets outperform the assumed appreciation rates at the time of the gift, the remaining amount passes to family members free of gift tax. This tax-free gift of excess appreciation can be enhanced further by minimizing payments to the charity during the early years of the CLAT and increasing them over time.

The proposal would require the value of the remainder interest for gift tax purposes at the creation of the CLAT equal at least 10% of the value of the property contributed to the CLAT such that it would no longer be possible to "zero-out" a CLAT. The proposal would also require level, fixed annuity payments be paid to the charity during the term of the CLAT. The proposal would apply to all CRATs created after date of enactment.

KPMG observation

In addition to preventing taxpayers from creating more traditional "zeroed-out" CLATs, this proposal would also preclude use of a technique known as a "Shark Fin CLAT". A Shark Fin CLAT provides for a very modest annuity payment for most of the CLAT term with a significant increase in the annuity

payment at the end of the term. (It gets its name from the graph of these annuity payments over time.) As mentioned above, this delay in making distributions to charity potentially allows for more growth in the assets and a larger gift tax benefit. If enacted, this proposal would eliminate this technique by requiring a constant annuity amount during the term.

Modify the tax treatment of loans from a trust

Although non-grantor trusts can be subject to income tax as separate taxable entities, they also serve as conduits when they make distributions to beneficiaries; a trust's income is allocated between the trust and its beneficiaries, ensuring that income is only taxed once, under various provisions of the Code. There can also be transfer tax consequences associated with trust distributions (whether from grantor trusts or non-grantor trusts)—for example, distributions from non-exempt trusts to the grandchild of the grantor or other skip person could be subject to GST tax. However, except for certain loans from a foreign trust to a U.S. person, a bona fide loan from a trust does not carry with it any tax consequences to the borrower, although it does result in economic consequences in the form of the obligation to pay interest on the debt as well as to ultimately repay the principal.

The proposal would treat a loan made by a trust to a beneficiary as a distribution for income tax purposes, carrying out an appropriate portion of taxable income to the borrower. Additionally, the loan would be treated as a distribution for GST tax purposes, potentially subject to GST tax if the loan is to a skip person beneficiary (and presumably only if the trust is not otherwise exempt from GST). If the loan is repaid, a refund of the GST tax paid, with interest (only from the date of the claim for refund), could be refunded to the party that incurred the GST tax liability initially (e.g., the beneficiary in the case of a taxable distribution).

With respect to loans to the grantor-owner of a grantor trust (or the spouse of the grantor-owner), the repayment of any loan to the trust would be treated as a new contribution by the borrowing deemed owner for GST tax purposes. As with any contribution to a trust, there could be GST tax consequences at that time depending on the terms of the trust—GST tax liability in the case of a direct skip, an opportunity to allocate GST exemption, or an increase in the trust's inclusion ratio if exemption is not allocated.

The proposal allows for regulations to be drafted that would identify certain loan types that would not be subject to this proposal. It is indicated that, for example, this authority could be used to exempt short term loans or short-term permission to use real or tangible property owned by the trust.

The proposal would apply to loans made, as well as to existing loans renegotiated or renewed, by trusts after the year of enactment.

KPMG observation

The reference to a regulatory exception for short term permission to use real or tangible property may indicate that the proposal itself is intended to apply not only to actual loans but also to allowing a beneficiary to use trust property. This would be similar to the current rules applicable to interactions between a foreign trust and a U.S. person beneficiary.

KPMG observation

It is not entirely clear whether the proposal regarding borrowing by a deemed owner under the grantor trust rules would apply to borrowing by a beneficiary who is treated as the owner of the trust in accordance with section 678 of the Code or whether it would be limited to grantor-owners. If beneficiary-owners are included, payback of the loan by that person would then cause the trust to have more than one transferor for GST tax purposes and require the calculation of a separate

inclusion ratio for that transferor. Beneficiary generation assignments would then need to be tracked with respect to the additional deemed transferor.

KPMG observation

Since the payback of a loan by the grantor-owner of a grantor trust would be treated as an additional contribution by the grantor if this proposal were enacted, care should be taken to generally not have the grantor borrow funds from a GST grandfathered trust (because the additional contribution might be treated as voiding the grandfathered status) or from a trust that otherwise has a zero-inclusion ratio unless the grantor has enough remaining GST exemption to cover the additional contribution.

Revise rules for valuation of certain property

Require consistent valuation of promissory notes

Generally, an individual who lends money at a below-market rate of interest to another individual is treated as making a gift for gift tax purposes and the lender is imputed a commensurate amount of income for Federal income tax purposes. In order to avoid those consequences, the interest rate must be at least equal to the minimum monthly rate (based on the duration of the loan) issued by the IRS. Sometimes a taxpayer will enter into a loan that bears this "safe harbor" interest rate, taking the position that the loan is not below market for gift tax purposes, but subsequently discounts the value of the unpaid note for gift or estate tax purposes because the interest rate is below the current market rate or because of other underlying economic characteristics (such as a very lengthy term).

The proposal would impose a consistency requirement by providing that, if a taxpayer treats any promissory note as having a sufficient rate of interest to avoid the treatment of any foregone interest on the loan as income or any part of the transaction as a gift, that note subsequently must be valued for Federal gift and estate tax purposes by limiting the discount rate to the greater of the actual rate of interest of the note, or the applicable minimum interest rate for the remaining term of the note on the date of death. The Secretary would be granted regulatory authority to establish exceptions to account for any difference between the applicable minimum interest rate at the issuance of the note and actual interest rate of the note. In addition, if there is a reasonable likelihood that the note will be satisfied sooner than the specified maturity date, the Secretary could treat the note as being short term regardless of the due date, value term loans as demand loans in which the lender can require immediate payment, or reduce the stated term to earliest possible date on which the related property could be monetized.

The proposal would apply to valuations as of a valuation date on or after the date of enactment.

Revise the valuation of partial/fractional interests in certain assets transferred intrafamily

The gift and estate tax apply to the fair market value ("FMV") of the transferred property. FMV for gift or estate tax purposes is the price at which the property would change hands between a willing buyer and a willing seller. A buyer would pay less and a seller would accept less for a minority interest in a closely held enterprise than they would for a proportionate share of the underlying assets because of the interest's inherent limitations on access to the economic benefits. These limitations are reflected through the application of discounts on the underlying asset value for: (1) lack of control – applicable to a minority interest in a business because the owner of such an interest cannot unilaterally make management decisions or control distributions; and (2) lack of marketability – applicable to an interest in a closely held business because the owner of such an interest cannot easily liquidate or transfer his interest due to the limited market or universe of buyers and restrictions on transferability.

When taxpayers make intrafamily transfers of interests in such entities (instead of transferring the underlying assets themselves), they often claim entity-level discounts in valuing the gift, leveraging their lifetime exemption and minimizing transfer tax exposure. Section 2704(b) of the Code disregards the effects on FMV of liquidation restrictions on controlled partnerships and corporations in limited circumstances but does not modify the FMV of partial interests in assets.

The proposal would replace section 2704(b) of the Code and provide that the FMV of a partial interest in non-publicly traded property (real or personal, tangible or intangible) transferred to or for the benefit of a family member of the transferor would be the interest's pro rata share of the collective FMV of all interests in that property held by the transferor and the transferor's family members (directly, through a general partnership or wholly owned entity, or in a trust for the person's sole benefit or that is revocable). Family members for this purpose would include the transferor, the transferor's ancestors and descendants, and their spouses. This rule would not apply to the portion of the interest attributable to assets actively used in the conduct of a trade or business; rather it would apply to the portion of the interest attributable to passive assets. In addition, the special valuation rule would only apply if the family collectively (after attributing to a member the maximum interest held through an entity or trust) had an interest of at least 25% of the whole.

The proposal would apply to valuations as of a valuation date on or after the date of enactment. A proposal directed at the same issue but utilizing a different approach was included in the House Ways and Means Committee recommendations for the Build Back Better Act.

KPMG observation

The IRS has historically taken the position that valuation discounts should not apply in certain circumstances – for example, gifts of family limited partnership interests where the partnership holds marketable securities or other liquid assets and the partnership is owned and controlled by family members. Consistent with this position, the IRS and Treasury proposed regulations under section 2704 in 2016. These regulations were criticized as being too broad, as overthrowing the willing buyer-willing seller standard of "fair market value," as exceeding Treasury's statutory authority, and as destroying family-owned businesses. Ultimately, they were withdrawn in 2017 in response to President Trump's executive order that agencies identify recent regulations that imposed an undue financial burden on taxpayers or added undue complexity to the tax laws or exceeded the agency's statutory authority. This proposal may be intended to acquire the requisite statutory authority to support the IRS's attack on entity-level (or partial interest) discounts in the intrafamily context.

Close "loopholes"

Tax carried (profits) interests as ordinary income

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

The Green Book generally indicates that the administration's proposal would tax as ordinary income a partner's share of income from an investment services partnership interest (ISPI) in an investment partnership; would require the partner to pay self-employment taxes on such income; and generally would treat gain recognized on the sale of such interest as ordinary. An ISPI generally would be an interest in an

investment partnership that is held by a person who provides services to the partnership. A partnership would be an investment partnership only if: (1) substantially all of its assets were investment-type assets (certain securities, real estate, interests in partnerships, commodities, cash or cash equivalents, or derivative contracts with respect to such assets); and (2) over half of the partnership's contributed capital was from partners in whose hands the interests constitute property not held in connection with a trade or business. As with similar past proposals, the administration's proposal provides exceptions for "invested capital," as well as anti-abuse rules applicable to certain "disqualified interests."

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

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

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

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

The proposal would be effective for tax years beginning after December 31, 2023.

Repeal deferral of gain from like-kind exchanges

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

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

The proposal would be effective for exchanges completed in tax years beginning after December 31, 2023.

Treasury estimates that the proposal would raise $18.574 billion over 10 years.

KPMG observation

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

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

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

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

The administration proposes to have this change effective for exchanges **completed** in tax years beginning after December 31, 2023. By focusing on the date on which an exchange is completed, the administration's proposal could apply to exchanges that begin prior to January 1, 2024. In particular, the proposal could impact any like-kind exchange that begins on or after July 5, 2023, if the taxpayer relies on the entire 180-day exchange period for completing the exchange.

Require 100% recapture of depreciation deductions as ordinary income for certain depreciable real property

The administration's proposal would require gain on the disposition of section 1250 property held for more than one year to be treated as ordinary income to the extent of depreciation deductions taken after the effective date, which is proposed to be tax years beginning after 2023. Section 1250 property includes tangible and intangible real property that is not otherwise defined as section 1245 property.

Under current law, gain on the disposition of section 1250 property held for more than one year is only required to be treated as ordinary income to the extent that depreciation claimed on the asset exceeds depreciation that would have been claimed had depreciation been computed using a straight-line method. The proposal would result in identical treatments of disposition gains under sections 1245 and 1250 for most taxpayers.

The proposal would not apply to individual taxpayers with AGI lower than $400,000, or $200,000 for married individuals filing separately. Flow-through entities would be required to compute and report gains and losses on section 1250 property under both old and new law. The 25% rate for unrecaptured section 1250 gain for individuals remains unchanged, although the amount of unrecaptured section 1250 gain would generally decrease under the proposal.

Limit use of donor advised funds to avoid a private foundation payout requirement

The proposal provides that a private foundation's distribution to a donor advised fund (DAF) would not be a qualifying distribution unless:

- The DAF distributes the funds by the end of the following tax year as a qualifying distribution, which would not include a distribution to another DAF
- The private foundation maintains records or other evidence confirming that the DAF distributed the funds as qualifying distributions within the required time

Currently, private non-operating foundations must distribute 5% of their non-charitable use assets annually (the "5% payout"). However, they cannot count amounts distributed to a controlled entity or another private non-operating foundation toward that 5% payout unless the funds are in turn distributed by the recipient "out of corpus" by the end of the following tax year as qualifying distributions.

The proposal states that it would be effective after the date of enactment.

KPMG observation

This proposal is similar to a proposal introduced in Congress in 2021 and 2022, which would have effectively treated distributions by private non-operating foundations to DAFs the same as distributions to controlled entities and other private non-operating foundations for purposes of the 5% payout. If enacted, a grant from a private non-operating foundation to a DAF would only count as a qualifying distribution if the DAF re-distributed the funds "out of corpus" as a qualifying distribution by the end of the following tax year. "Out of corpus" is a term of art referring to qualifying distributions in excess of the qualifying distributions required under the 5% payout (or, in the case of a recipient that is a public charity, that would be required if a 5% payout applied to the public charity). In applying this "out of corpus" concept to a DAF, the prior Congressional proposals have been unclear regarding whether a notional 5% payout would be determined at the level of the DAF or the level of the charity that maintains the DAF (commonly referred to as the "sponsoring organization").

Exclude payments to disqualified persons from counting toward private foundation payout requirement

The proposal provides that a private foundation's payment of compensation or reimbursements of expenses to certain "disqualified persons" (namely, substantial contributors, their family members, and certain entities owned by them) would not be a qualifying distribution that would count toward the foundation's 5% payout.

The proposal would be effective for payments made and expenses reimbursed after the date of enactment.

KPMG observation

This proposal is similar to one introduced in prior Congressional proposals in 2021 and 2022. That proposal applied only to "administrative expenses," rather than all payments of compensation and reimbursements of expenses.

Extend the period of assessment of tax for certain Qualified Opportunity Fund (QOF) investors

Section 6501 generally requires that the IRS assess a tax within three years after the filing of a tax return. If a taxpayer invests an amount of eligible gain in a Qualified Opportunity Fund (QOF) and elects deferral, that amount of eligible gain is excluded from the taxpayer's income for the year that the gain is realized. A taxpayer who deferred gain under section 1400Z-2 by investing in a qualified opportunity fund will generally recognize the deferred gain upon the earlier of (i) the occurrence of an inclusion event or (ii) December 31, 2026. An inclusion event, in general, is any reduction of a taxpayer's equity interest in the qualified opportunity fund, including the sale of interests in the fund and certain distributions by the fund to the taxpayer. Recognition of the gain deferred under section 1400Z-2 may not occur until many years after the filing of the return for the year in which the gain was realized.

The administration's proposal would provide the IRS with an extension of time to assess any deficiency resulting directly or indirectly from a taxpayer's failure to include, or properly reflect the inclusion of, gain deferred in a QOF following the occurrence of an inclusion event. Under the proposal, the time during which the IRS could assess a deficiency resulting directly or indirectly from such failure would not expire before the date that is three years after the date on which IRS is furnished with all the information needed to assess the deficiency.

The proposal would generally be effective for inclusions of deferred gains associated with any QOF investment made after December 22, 2017 (the date of enactment of the TCJA). The proposal, however, would not apply in situations where the statute of limitations has expired prior to the date of enactment of the proposal.

Treasury estimates that the proposal would raise $90 million over 10 years.

KPMG observation

The reporting requirements for qualified opportunity fund investors, if complied with, ought to provide the IRS with sufficient information to identify when an inclusion event has occurred with respect to a particular investor. For example, an investor with an inclusion event must (i) file a Form 8949, *Sales or Other Dispositions of Capital Assets* reporting the gain triggered by the inclusion event, and (ii) reflect the inclusion event on Form 8997, *Initial and Annual Statement of QOF Investments*. In addition, if the investor disposes of an interest in the qualified opportunity fund, the fund would report the disposition to the IRS on Form 8996.

Despite the various reporting requirements, the administration's proposal reflects a concern that the occurrence of an inclusion event may not be "readily identifiable" on taxpayers' returns. However, if a taxpayer was not aware that an inclusion event occurred (for example, because the taxpayer is invested through a chain of partnerships and is not aware of the inclusion event at a lower-tier partnership) or if the taxpayer simply failed to properly report the inclusion, the IRS would be unaware that the taxpayer should have included the deferred gains. If enacted, the administration's proposal would prevent the IRS from being barred from assessing a deficiency under the general statute of limitations in that circumstance.

The wording of the proposal is quite broad. If enacted as described, the extended statute of limitations would apply not only when the taxpayer failed to include the deferred gain but also if the taxpayer "in any way fails to properly reflect on one or more tax returns" the required inclusion. It is unclear whether this broad language would allow the IRS to keep the statute of limitations open for minor mistakes in reporting the gain, despite the gain having been properly included in income.

Modify rules for insurance products that fail the statutory definition of a life insurance contract

Rules governing failed life insurance contracts would be modified in several respects to ensure that all policyholder earnings are taxed, and not included in tax-exempt death benefits. The proposal identifies a specific type of foreign-issued life insurance contract, a "frozen cash value (FCV)" contract, that does not allow access to the policy's value via withdrawals of cash value, loans, or surrenders. The net surrender value of a FCV contract will never exceed the premiums paid for the contract, and in many cases the net surrender value will be less than the premiums paid. Generally, US states have non-forfeiture laws that prohibit the sale of such contracts by US-based life insurance companies. The proposed change to section 7702(g) would fully tax to the policyholder the earnings accruing on a failed contract's underlying investments, as well as the mortality charges. The goal would be accomplished through three proposed changes.

First, the current law definition of income for a failed contract would be modified by substituting "net investment value" for net surrender value. A failed contract's net investment value would be defined as the amount representing the contract's death benefit, less the contract's amount at risk and any specific charges that might be imposed upon a contract's surrender. This change would mean that the policyholder of any failed contract (including FCV contracts) would be subjected to current taxation on the earnings credited to that contract.

Second, amounts distributed and policy loans from a failed contract would be deemed to be amounts distributed or loaned under a modified endowment contract. For this purpose, the definition of investment in the contract would be amended to include income on the contract that has been taxed prior to the distribution or loan date, other than amounts equal to the cost of life insurance protection.

Third, the excess of the amount paid by the reason of the death of the insured over the net investment value of the contract would be treated as death benefits when calculating taxable income.

These changes are intended to help ensure that all future earnings credited to FCV contracts owned by U.S. persons would be included in the U.S. policyholder's "income on the contract" for the tax year. For contracts that become failed contracts after the proposal's effective date, any prior amounts of untaxed investment value would become taxable.

The proposal would be effective for life insurance contracts under the applicable law as of the day following the date of publication of the *General Explanation of the Administration's Fiscal Year 2024 Revenue Proposals,* March 9, 2023. For a tax year including this effective date, "income on the contract" would be defined as two quantities. The first would use the definition under current law, but the date of publication would be treated for this purpose as the end of a tax year, while the second component would use the proposal's definition, and the effective date would be treated as the beginning of a tax year.

Treasury estimates that the proposal would raise $4 million over 10 years.

KPMG observation

In general, investment earnings credited to qualified life insurance policies are not taxable until deemed distributed. Cash distributions from a life insurance contract are generally treated as coming first from the investment in the contract (equal to aggregate premiums paid, less aggregate untaxed distributions), thus not taxable until all the investment has been withdrawn.

If a life insurance contract fails to comply with the requirements of section 7702(a), the tax deferral accorded to life insurance contracts will be lost. Instead, under section 7702(g), "income on the contract" will accrue each year from the date of failure. "Income on the contract" for this purpose is defined as the excess of the sum of the increase in the net surrender value during the tax year and

the cost of life insurance protection for such year, over the premiums paid during such year. Also, in the year of failure, the income on the contract accruing in all prior contract years is treated as received or accrued by the taxpayer. The contract's net amount at risk, calculated for this purpose as the difference between the death benefit and the net surrender value, continues to be excludible from income under section 101 to the same extent as death benefits under complying contracts.

Policy loans received during the life of the insured are generally considered to be nontaxable to the extent that they are limited to premiums paid and therefore deemed to be a return of the contract's basis.

For tax purposes, FCV contracts are designed to be life insurance contracts under the applicable foreign law but failed life insurance contracts under the U.S. Tax Code. A U.S. taxpayer who is a policyholder of such an FCV contract is subject to tax on the policy's "income on the contract," which will typically be zero or very low according to the IRS because the net surrender value of an FCV contract is attributable only to premium payments and the cost of insurance protection also is relatively small and could be zero. In addition, increases in a FCV contract's asset value are not included in taxable income because they are either offset by a payment of premiums during the tax year or are not part of a contract's net surrender value. Furthermore, both partial withdrawals and policy loans received during the life of the insured are generally considered to be nontaxable because they are limited to premiums paid and therefore deemed to be a return of the contract's basis.

FCV-type contracts allow US taxpayers to avoid paying tax on income that would otherwise be taxable. This provides an advantage to foreign life insurance companies over U.S.-based life insurers because U.S.-based life insurance companies are prohibited from selling these products. These proposed changes, however, do not keep U.S. taxpayers from buying life insurance from foreign life insurance companies when such foreign-issued policies meet the U.S. taxpayer's needs.

Define the term "ultimate purchaser" for purposes of diesel fuel exportation

In general, an excise tax is imposed by section 4081 on taxable fuel, including diesel fuel and kerosene. If diesel fuel or kerosene upon which the tax was imposed is exported, the Internal Revenue Code deems the exportation a non-taxable use of the fuel and a credit or refund of tax is allowed to the "ultimate purchaser" of such fuel. However, the term "ultimate purchaser" is not defined in the Internal Revenue Code. Under current law, it is possible in some cases for both the last U.S. purchaser and the foreign customer to qualify as the ultimate purchaser for this purpose. Current regulations require as conditions to allowance of the claim that tax was imposed on the fuel, the fuel was exported from the United States, the claim was timely filed, and the claim included certain information. Under current law, it is possible for more than one person to qualify as the ultimate purchaser, resulting in the IRS paying a refund of tax twice with respect to the same volume of exported diesel fuel or kerosene.

The proposal would define the person entitled to the refund as the last purchaser in the United States for purposes of diesel fuel and kerosene exportation.

The proposal would be effective for diesel fuel and kerosene exported after December 31, 2023.

KPMG observation

The proposal would address a situation in which it is possible for more than one person to claim a refund of tax with respect to the same quantity of fuel as a result of the exportation of such fuel under current law.

Improve tax administration

Modify the requirement that general counsel review certain offers in compromise

Section 7122 authorizes the Secretary to enter into an agreement with a taxpayer that settles the taxpayer's tax liabilities for less than the full amount owed if the taxpayer's case has not been referred to the Department of Justice. Such an agreement is known as an offer in compromise (OIC). The IRS is authorized to compromise a liability on grounds of doubt as to liability, doubt as to collectability, or the promotion of effective tax administration. Section 7122(b) requires the General Counsel of the Department of the Treasury, or their delegate, to review and provide an opinion in support of OICs where the unpaid amount of tax assessed (including any interest, additional amount, addition to tax, and assessable penalty) is $50,000 or more. The General Counsel has delegated legal review of OICs to the Chief Counsel of the IRS, who has delegated that authority to the Small Business/Self-Employed Division Counsel (Counsel).

The Green Book observes that the IRS receives thousands of OIC applications every year and must verify that the requirements for an OIC are met prior to proposing acceptance. The concern stated with current law is that the time Counsel spends on reviewing offers already reviewed by other IRS employees may delay acceptance of offers, which may result in financial uncertainty or harm to taxpayers, while providing no additional protection of taxpayer rights.

The proposal would amend section 7122(b) to repeal the requirement that General Counsel review all offers in compromise where the unpaid amount of tax assessed (including any interest, additional amount, addition to tax, or assessable penalty) is $50,000 or more and instead authorize the Secretary to require Counsel review of offers in compromise only in cases that the Secretary determines present significant legal issues.

The proposal would be effective for offer in compromise applications submitted after the date of enactment.

KPMG observation

By removing the OIC review threshold, discretion is placed solely with Treasury to determine whether a specific OIC warrants review by Counsel. Seemingly, as stated in the Green Book, this will allow OICs, where the amount of unpaid tax is $50,000 or more, to move through the IRS administrative process more quickly, as Counsel is no longer required to review based solely on the amount of tax due. As the IRS continues to work through the administrative challenges posed by COVID-19, the proposal reflects continued contemplation on whether an administrative requirement is achieving its policy goal, or rather, has developed into a requirement that more likely hinders the Service, and taxpayers. Further, the $50,000 tax assessment threshold would logically encompass a greater number of taxpayers seeking OICs today than it did when the current $50,000 threshold was enacted in 1996. As the proposed law change only references the undefined term "significant legal issues," one would anticipate corresponding regulations, or at the least informal guidance or procedures, to be issued to set expectations on, and to establish parameters applicable to, when Treasury intends to seek Counsel review on an OIC.

Incorporate chapters 2/2A in centralized partnership audit regime proceedings

The centralized partnership audit regime, as enacted by the Bipartisan Budget Act of 2015 (BBA), applies to chapter 1 income tax, but does not apply with respect to taxes imposed under chapter 2 (SECA) and chapter 2A (NIIT). Any partnership adjustment determined under the BBA for purposes of chapter 1, however, must be taken into account for purposes of determining any chapter 2, 2A tax, to the extent such adjustment is relevant to such determination. Therefore, although the BBA establishes a centralized audit and adjustment regime for partnerships, the rules currently separate the treatment of chapter 1 and chapter 2/2A adjustments for reporting, tax calculation, and assessment purposes. This disparate treatment requires taxpayers to file multiple tax returns to meet their filing obligations and requires the IRS to follow separate proceedings to meet its enforcement obligations.

In general, the IRS must determine partnership adjustments impacting the Chapter 1 liability of any partner by conducting a BBA proceeding at the partnership level. At the conclusion of the BBA proceeding, the IRS generally assesses and collects tax from the partnership in the form of an imputed underpayment, unless the partnership elects to push out the adjustments to its reviewed year partners. In contrast, with respect to Chapters 2/2A taxes that result from a BBA proceeding, the IRS must assess and collect these taxes from individual partners, rather than the partnership. According to the Greenbook, these cumbersome procedures, which require linking impacted partners' returns to the BBA return under examination and in some case require examinations of partners' returns, are contrary to the intent that the BBA streamline tax administration of partnership examinations. Furthermore, for partnerships that file administrative adjustment requests (AARs) and push out adjustments to reviewed year partners or for partners that file amended returns under the modification procedures, such partners must separately amend their reviewed year income tax returns to pay any Chapter 2/2A taxes attributable to the adjustments made on the AAR or in the partnership proceeding.

The proposal would expand the scope of the BBA beyond Chapter 1 by:

- Amending the definition of a BBA Partnership-Related-Item to include items that affect a person's Chapter 2/2A taxes
- Applying the sum of the highest rates of tax in effect for the reviewed year under section 1401(b)(1) and (b)(2) to these items

The proposal would be effective after the date of enactment for all open tax years.

KPMG observation

Many questions remain as to how the proposed amendments would be implemented and how they would affect the BBA regime, such as whether the rules relating to the push-out election under section 6226 and the rules relating to modifications of the imputed underpayment under section 6225 also would be amended. Under current law, partners that receive push out adjustments or that file amended returns (or the alternative to amended returns) in modification are required only to pay chapter 1 tax. The proposed change could lead to rethinking and redrafting substantial parts of the BBA regime.

Expand TIN matching and improve child support enforcement

The Taxpayer Identification Number (TIN) Matching Program is a pre-filing service offered by the IRS for payors of certain reportable payments subject to the backup withholding provisions of section 3406. The TIN Matching Program enables taxpayers that file certain information returns to validate TIN and name combinations prior to submission of the information returns.

No information other than a numerical indicator for the validity of the match is disclosed. The TIN Matching Program only applies to reportable payments under section 3406. Therefore, the Program does not apply to a number of widely-used information returns, including Form 1098, *Mortgage Interest Statement*; Form 1098-T, *Tuition Statement*; Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*; Form 5498, *IRA Contribution Information*, 1099-G, *Certain Government Payments*; Form 1099-S, *Proceeds from Real Estate Transactions*, and Form 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding*.

The proposal would amend section 6103 to permit TIN matching for filers of all information returns requiring the reporting of names and TINs.

This proposal would be effective upon enactment.

KPMG observation

Various stakeholders over the years have urged the IRS to expand the TIN Matching Program. There has been uncertainty whether the IRS has the legal authority to do so beyond its current scope, which limits the program to payers of amounts potentially subject to backup withholding. Providing the legal framework to expand the program should be welcome news to many and allow a wider number of information return filers the opportunity to verify name-TIN combinations upfront, thereby avoiding IRS notices and possible penalties for filing information returns with incorrect TINs.

Clarify that information previously disclosed in a judicial or administrative proceeding is not return information

Section 6103(a) prohibits the disclosure of returns and return information unless a provision of Title 26 provides otherwise. Section 6103 contains several exceptions to this general rule. These exceptions authorize the disclosure of specific return information in specific circumstances; however, the scope of these exceptions can be limited.

For example, although section 6103(h) permits certain disclosures of returns and return information in judicial and administrative tax proceedings, neither this exception nor any other section 6103 exception explicitly creates a general authorization to redisclose return information that has previously been disclosed during a judicial or administrative proceeding and become public information as a result. In abusive transaction cases, it is common for the Department of Justice to issues press releases as a tool to encourage taxpayer compliance across a broad audience. For example, by announcing the filing of a complaint in abusive tax transactions cases, the government alerts taxpayers that certain transactions and conduct will draw the attention of the government and that the government will seek to enjoin those transactions and conduct. Such press releases relating to information previously disclosed in a judicial or administrative proceeding and that has become public record are not explicitly referenced in section 6103.

Similarly, section 6103(l)(6) authorizes the IRS to disclose certain return information to Federal, State, and local child support enforcement agencies and their contractors. However, there is no explicit authority in section 6103(l)(6) or elsewhere in section 6103 for the IRS to disclose return information to Tribal child support enforcement agencies (CSEs) or their contractors for purposes of child support enforcement. Because section 6103(l)(6) does not authorize disclosing return information to Tribal CSEs for purposes of child support enforcement, Tribal CSEs or their contractors are not able to use return information to establish or collect child support or locate individuals with child support obligations.

In addition to the section 6103 limitations, Tribal CSEs are not able to use the Federal tax refund offset program that collects past-due child support payments from the tax refunds of parents who owe support because they are not listed in section 6402.

The proposal would make the following changes:

- Amend section 6103(b)(2) to clarify that information previously disclosed pursuant to section 6103 in the course of any judicial or administrative tax proceeding and made a part of the public record thereof, including information disclosed in any Notice of Federal Tax Lien filed in accordance with section 6323 of the Code or related filings, is not return information protected from disclosure by section 6103;
- Amend 6103(l) to specifically authorize Tribal CSEs and their contractors the same access to the same return information as Federal, State, and local CSEs; and
- Amend section 6402(c) of the Code to provide Tribal CSEs with access to the Federal tax refund offset program.

These proposals would be effective upon enactment.

KPMG observation

The proposal is focused, in part, on press releases issued by the government relating to information previously disclosed in a judicial or administrative proceeding and that has been made part of the public record. The reference to the public record appears central to the proposal's recommendation to no longer protect this type of information from disclosure. The IRS has argued that tax information placed in the public record in connection with tax administration is no longer confidential and cannot be "disclosed" within the meaning of section 6103(b)(8) if the IRS has already lawfully made such information known in public records during tax administration activities. The absence of express statutory authority in section 6103 for the disclosure of such information, however, has generated conflicting case law in the circuit courts of appeal. Given this uncertainty, the IRS instructs its employees to exercise caution before using the public record exception as a basis for the release of otherwise confidential tax information. See Internal Revenue Manual 11.3.11.12, Information Which Has Become Public Record (June 21, 2022).

Improve tax compliance

Address taxpayer noncompliance with listed transactions

Generally, the IRS must assess a tax within three years after the date the return is filed, subject to several exceptions. One such exception applies if a taxpayer fails to include, on any return or statement, information that is required with respect to a listed transaction. In that case, the IRS has additional time to assess any tax with respect to such listed transaction. The amount of additional time depends on when the information related to the listed transaction is ultimately furnished to the IRS. See section 6501(c)(10).

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

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

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

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

KPMG observation

The justification for the potential extension of the statute of limitations for all items on a taxpayer's return (not just those arising from a listed transaction) is unclear. The listed transaction rules apply where a taxpayer has engaged in certain, designated "tax-avoidance" transactions to reduce tax liability. However, most other instances in which a taxpayer misreports tax liability are addressed by the general statute of limitation rules, and it is not clear why engaging in a listed transaction should alter the general statute of limitation rules for any items on a taxpayer's return not tied to that listed transaction.

The proposal would also impose secondary liability on selling shareholders who directly or indirectly sell or dispose of a 50% or greater interest (a "controlling interest") in the stock of an "applicable C corporation" for payment of the C corporation's U.S. federal income taxes (plus interest, additions, and penalties) to the extent of the sales proceeds received by the shareholders. The liability would arise only after the applicable C corporation was assessed these amounts with respect to any tax year within 12 months before or after the date the stock was sold or disposed of, and only after the applicable C corporation did not pay such amounts within 180 days after assessment. For these purposes, an "applicable C corporation" is a C corporation (or a successor) two-thirds of whose assets are comprised of cash, passive investment assets, or assets that are the subject of a contract of sale (or whose sale has been substantially negotiated on the date that the stock is sold or disposed of). Exceptions would apply to dispositions of publicly-traded C corporation, REIT, or RIC stock, and to C corporation shares acquired by publicly traded acquirers. The proposal would close the tax year of the applicable C corporation as of the later of a disposition of the controlling interest in its stock or on a disposition of all of its assets. In addition, an additional year would be added to the statute of limitations on assessment against the selling shareholders. The secondary liability proposal would be effective for sales of controlling interests occurring on or after April 10, 2014, and is estimated to raise $5.5 billion over the 10-year budget window.

KPMG observation

The first thing to note about the secondary liability proposal is its retroactive effective date—it is proposed to be effective for sales of controlling interests in stock of an applicable C corporation occurring on or after April 10, 2014 (more than eight years prior to the date the proposal was released).

The second thing to note is that recent court decisions have concluded that certain IRS notices identifying listed transactions are rules subject to the Administrative Procedure Act's notice-and-comment rulemaking process. The failure to follow notice-and-comment requirements have led these courts to "set aside" and vacate the IRS notices. See, e.g., *Mann Construction, Inc. v. United States*, 27 F.4th 1138 (6th Cir. 2022) (invalidating Notice 2007-83) and *Green Valley Ranch Investors, LLC v. Comm'r*, 159 T.C. No. 5 (2022) (invalidating Notice 2017-10).

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

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

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

Impose an affirmative requirement to disclose a position contrary to a regulation

Section 6662(b)(1) of the Internal Revenue Code imposes a 20% accuracy-related penalty on underpayments attributable to disregard of a rule or regulation. In general, this portion of the accuracy-related penalty does not apply if the taxpayer adequately discloses, via Form 8275-R, *Regulation Disclosure Statement,* a tax position contrary to a regulation when it files its return. To avoid the application of this penalty, a position contrary to a regulation must represent a good faith challenge to the validity of the regulation, have a reasonable basis, and be properly substantiated. If the position contrary to a regulation relates to a reportable transaction, the taxpayer must also report the transaction in accordance with the reportable transaction rules. The accuracy-related penalty is subject to a reasonable cause and good faith exception.

Current law treats the disclosure of a position contrary to a regulation as a means to avoid imposition of the accuracy-related penalty. There is no affirmative obligation for taxpayers to inform the IRS that they are taking such a position. The Green Book's stated observation is that "in recent years" a growing number of taxpayers—especially large multinational entities—have taken tax positions on their returns that are contrary to a regulation and that such positions are difficult for IRS to identify if the taxpayer chooses not to

disclose them for penalty protection purposes. As the administration views it, a taxpayer could forgo penalty protection by filing a Form 8275-R, in hopes of avoiding scrutiny for taking a position contrary to a regulation.

The proposal would impose an affirmative requirement on taxpayers to disclose a position on a return that is contrary to a regulation. Except to the extent provided in regulations for failures due to reasonable cause and not willful neglect, a taxpayer who failed to make the required disclosure would be subject to an assessable penalty that was 75% of the decrease in tax shown on the return as a result of the position. Such penalty would not be less than $10,000 or more than $200,000, adjusted for inflation. The penalty would not apply if a taxpayer reasonably and in good faith believed that its position was consistent with the regulation. However, the penalty would apply regardless of whether the taxpayer's interpretation of the regulation is ultimately upheld.

The proposal would be effective for returns filed after the date of enactment.

KPMG observation

The proposed change would add to the growing list of disclosure obligations placed upon taxpayers as part of their annual income tax compliance and other federal tax compliance obligations, and it highlights the frequently stated premise that the IRS will be better equipped to conduct examinations and to more fairly administrate the tax laws if taxpayers disclose more information. With all the current disclosure obligations on taxpayers, adding another obligation raises the question as to the use and value of current disclosure obligations, if there is a belief that this proposal is necessary; although presumably the government would contend that this disclosure proposal is different than others as it requires taxpayers to disclose tax positions that, on their face, are contrary to the law. Most pointedly, because the proposal includes a minimum penalty of $10,000 the proposal would appear to apply a penalty *even if* the taxpayer's interpretation of the regulation was upheld by the IRS Independent Office of Appeals, or by a court of law. It is difficult to understand a policy where the taxpayer would be subject to a penalty for not disclosing a tax position while the taxpayer prevailed on the substantive merits of that tax position (and the taxpayer would not be subject to an accuracy-related penalty).

Require employers to withhold tax on failed nonqualified deferred compensation (NQDC) plans

Under section 409A, a NQDC plan must comply with various requirements including distribution and election timing rules. A failure to satisfy the section 409A requirements results in a 20% additional tax and possibly interest to an employee. Currently, employers have no withholding obligation for either the 20% tax or the interest. The proposal would require employers withhold the 20% tax and any applicable interest.

KPMG observation

The requirement for employers to withhold would make section 409A audits easier for the IRS by allowing an exam at the employer level instead of having to pursue an audit with each individual employee.

Extend to six years the statute of limitations for certain tax assessments

The Green Book lays out a proposal to extend the normal three-year statute of limitations to six years if there is an omission of more than $100 million of gross income. This resembles the extension of the statute under current law (§ 6501(e)(1)(A)) for substantial omissions from gross income, but would result in a much lower threshold for omission – and thus could lead to more frequent asserted statute extensions—for large

taxpayers. In describing this proposal, the Green Book specifically mentions the need for a longer statute to handle complex transfer pricing cases.

The proposed statute extension is unnecessary and would undermine, rather than improve, IRS Exam's handling of complex cases. In our experience, and as conceded in the Green Book, "taxpayers will typically consent to extend their statutes of limitations." While it is true, as the Green Book authors note, that any given extension of the statute may not extend the limitations period for as long as an examination team might wish, taxpayers are generally willing to continue extending the statute provided that the examination is progressing. Negotiated statute extensions provide an important tool for case management and act as a check on IRS exam teams, which, if not subject to the time pressures inherent in a statute of limitations, could allow examinations to drag on indefinitely, subjecting taxpayers to prolonged uncertainty.

Moreover, by predicating the applicable statute on the size of the adjustment, the proposal would effectively limit, and in some cases could completely eliminate, the IRS's willingness to settle cases. The goal of an examination is to determine on a principled basis by what amount, if any, a taxpayer's reported results should be adjusted; predicating the IRS's ability to continue an examination on the requirement that an adjustment of at least $100 million exists could hinder an IRS exam team's ability to make a correct determination. The incentive that is thus created to adhere to adjustments so that the statute remains open is not in keeping with the mission of the IRS, and does not reconcile with the goals of the IRS Independent Office of Appeals.

Increase the statute of limitations on assessments of the COVID-related paid leave and employee retention tax credits

The Families First Coronavirus Response Act of 2020 (FFCRA) enacted the paid sick and family leave tax credit (the paid leave tax credit) entitling certain employers to a refundable tax credit for the payment of qualified leave wages. The Coronavirus Aid, Relief, and Economic Security Act of 2020 (CARES Act) enacted the employee retention tax credit (ERTC) entitling certain employers to a refundable tax credit for the payment of qualified wages.

The paid leave tax credit and the ERTC applied to wages paid during the second, third, or fourth quarters of 2020. Subsequent legislation—the COVID-Related Tax Relief Act of 2020 (Relief Act) and American Rescue Plan Act of 2021 (ARPA)—extended the paid leave tax credit for qualified leave wages paid during the first, second or third quarters of 2021 and extended the ERTC for qualified wages paid during the first, second, third or fourth quarters of 2021. (The Infrastructure Investment and Jobs Act of 2021 amended the ERTC to apply only to wages paid prior to October 1, 2021, except for employers in limited circumstances).

Both the paid leave tax credit and the ERTC were claimed on employment tax returns, which generally are filed quarterly on Form 941. The due date for a quarterly Form 941 filing generally is the last day of the month following the quarter to which it applies – e.g., the due date for Form 941 in the first quarter of 2021 was April 30, 2021. The Relief Act expanded ERTC eligibility and applied retroactively to quarters with filing due dates that already had passed. To claim the ERTC for a prior quarter, an employer is required to file an amended employment tax return, generally on Form 941-X, for each earlier quarter.

In general, under section 6511(a) taxpayers must file a claim for credit or refund within the later of three years from the time the tax return was filed or 2 years from the time the tax was paid. Similarly, as a general rule, the IRS must assess taxes within three years after the filing of a return. The general period of limitations on assessment does not restart upon the filing of an amended return. For these purposes, if an employment tax return for a period ending with or within a calendar year is filed before April 15 of the succeeding calendar year, the return is considered filed on April 15 of that succeeding calendar year. Thus, an employer that timely filed and timely paid employment tax may file a claim for ERTC with respect to any quarter of 2020 by filing an amended employment tax return, generally Form 941-X, until April 15, 2024.

As a result of these timing rules, it is often the case that the assessment period expires at the same time as the period for a taxpayer to file a claim for credit or refund on an amended return. For example, all timely

filed Forms 941 for any quarter of 2020 were considered filed on April 15, 2021. Current law generally allows an employer that timely filed a Form 941 for any quarter of 2020 to submit a claim for credit or refund for that quarter of 2020 as late as April 15, 2024 (three years after April 15, 2021). The assessment period for the same quarter would also expire on April 15, 2024 (three years after April 15, 2021).

ARP extended the assessment period from three to five years for any amount attributable to the paid leave tax credit and the ERTC that was improperly claimed. Thus, the limitation period for assessment of erroneous ARP paid leave credits and ERTC will not expire before the date that is five years after the later of (1) the date on which the original return that includes the calendar quarter with respect to which the paid leave credit or ERTC is determined is filed, or (2) the April 15 date on which the return is treated as filed. However, the ARP extension applies only for the second and third quarters of 2021 for the paid leave tax credit and the third and fourth quarters of 2021 for the ERTC. The FFCRA and the CARES Act did not include extensions of the limitations period. Accordingly, the ARP's extended limitations period applies only for two of the six quarters in which an employer may claim the paid leave tax credit and only for two of the eight quarters in which an employer may claim the ERTC.

According to the Greenbook, because the current-law three-year limitations period applicable to the paid leave tax credits and the ERTC does not restart when an amended return is filed, a three-year assessment limitations period makes it difficult for the IRS to audit the amended returns and timely assess any tax, if warranted.

To address this concern, the proposal would extend the limitations on the time period for the assessment of erroneous paid leave tax credits under the FFCRA and the ERTC under the CARES Act, as amended prior to the ARP, to conform with the same five-year period provided under ARP.

The proposal would be effective on the date of enactment.

Expand and increase penalties for noncompliant return preparation and e-filing and authorize IRS oversight of paid preparers

Under current law, any person who is paid to prepare, or assists in preparing, Federal tax returns must identify themselves on those returns by using a prescribed identifying number. Under the applicable regulations, that number is a valid Preparer Tax Identification Number (PTIN) issued by the IRS. Paid tax return preparers must sign and include their PTIN on the return.

However, although the Code authorizes the IRS to issue PTINs, it does not authorize the IRS to revoke or rescind issued PTINs when the paid tax return preparer misuses or abuses taxpayers and/or the tax system. Furthermore, IRS does not have authority to address paid tax return preparers who are deemed to be unsuitable to prepare returns based upon a continual failure to comply with their own tax obligations.

Civil penalties and injunctive relief may be used to address preparer noncompliance. In general, penalties must be assessed within three years after the relevant return is filed. The civil penalties applicable to return preparers and the amounts of those penalties are listed below in Table 1.

In addition, although e-file providers must apply with the IRS and pass a suitability check before becoming an authorized e-file provider and receiving an Electronic Filing Identification Number (EFIN), there is no civil penalty on e-file provider misconduct.

KPMG observation

Under Title 31 of the United States Code, the Secretary has the authority to regulate licensed attorneys, CPAs, and enrolled agents and actuaries who practice before the IRS. These regulations

are colloquially known as Circular 230. In 2009, Treasury and the IRS amended the Circular 230 regulations to regulate practice of all paid tax return preparers, including prepares that are unlicensed and unenrolled. In 2014, the Court of Appeals for the D.C. Circuit determined that the 2009 amendments to the Circular 230 regulations exceeded the government's authority under Title 31. In 2014, the IRS also introduced its Annual Filing Season Program for non-credentialed return preparers. Prepares can voluntarily participate in the AFS program by completing 18 hours of continuing education and a federal tax law refresher course with accompanying test, after which the preparer will be listed in a database of credentialed return preparers.

Paid tax return preparers play an important role in tax administration because they assist taxpayers in complying with their obligations under the tax laws. Incompetent and dishonest paid tax return preparers increase collection costs, reduce revenues, disadvantage taxpayers, and undermine confidence in the tax system. The current lack of authority to provide Federal oversight on paid tax return preparers results in greater non-compliance when taxpayers who use incompetent preparers or unscrupulous preparers become subject to penalties and interest and incur litigation costs due to the poor-quality advice they receive. The lack of authority also affects government revenues when the resulting noncompliance is not mitigated by the IRS during return processing. Regulation of paid tax return preparers, in conjunction with diligent enforcement, will help promote high quality services from paid tax return preparers, will improve voluntary compliance, and will foster taxpayer confidence in the fairness of the tax system.

The administration's proposal would make the following changes:

- Increase the amount of the tax penalties that apply to paid tax return preparers for willful, reckless, or unreasonable understatements, as well as for forms of noncompliance that do not involve an understatement of tax;
- Establish new penalties for the appropriation of PTINs and EFINs and for failing to disclose the use of a paid tax return preparer. A $1,000 penalty would apply for each appropriation of a PTIN, with a maximum penalty of $75,000 for a calendar year. A $250 penalty would apply for each appropriation of an EFIN. Except for failures due to reasonable cause, a $500 penalty would apply for each failure by a taxpayer to disclose the use of a paid tax return preparer and the fees paid to such a preparer.
- For all of the new or increased penalties in the proposal, the specified dollar amounts and any applicable annual limitations would be adjusted for inflation.
- Expand the authority to determine the suitability of paid tax return preparers applying for identification numbers;
- Expand the authority to revoke identification numbers for paid tax return preparers subsequently determined to be unsuitable;
- Increase the limitations period during which the penalty for a failure to furnish the paid tax return preparer's identifying number may be assessed from three years to six years; and
- Clarify the Secretary's authority to regulate the conduct and suitability of persons who participate in the authorized e-file program, including setting standards and imposing sanctions to protect the integrity of the e-file program.

This proposal would be effective for returns filed after December 31, 2023.

The proposal would also amend Title 31 to provide the Secretary with explicit authority to regulate all paid preparers of Federal tax returns, including by establishing mandatory minimum competency standards. This proposal would be effective on the date of enactment.

Table 1

SUMMARY OF SELECTED PENALTIES FACED BY PAID TAX RETURN PREPARERS FOR NONCOMPLIANCE

	Calculation of Penalties			
NONCOMPLIANT BEHAVIOR	**CURRENT LAW**		**PROPOSAL**	
1. UPDATED PENALTIES FOR UNDERSTATEMENT OF LIABILITY				
Understatement due to …	Greater of $X or X% of income derived by preparer with respect to return or claim			
unreasonable conduct	$1,000 or 50%		$5,000 or 50%	
willful or reckless conduct	$5,000 or 75%		$10,000 or 100%	
2. UPDATED PENALTIES FOR REASONS OTHER THAN UNDERSTATEMENT OF LIABILITY				
Failure to …	Per Offence	Maximum	Per Offence	Maximum
furnish a copy of a return or a claim for refund to taxpayer	$55	$28,000	$250	$50,000
sign a copy of a return or a claim for refund	$55	$28,000	$1,000	$75,000
furnish preparer's identifying number	$55	$28,000	$1,000	$75,000
retain completed copy of prepared return or list of taxpayers for whom returns were prepared	$55	$28,000	$250	$50,000
file correct information returns identifying the return preparers employed by a person	$55	$28,000	$250	$50,000
refrain from endorsing or negotiating a check in respect of taxes	$560	None	$1,000	None
comply with certain due diligence requirements[2]	$560	None	$1,500	None
3. NEW PENALTIES ON PREPARERS, E-FILE PROVIDERS, AND TAXPAYERS:				
NONCOMPLIANT BEHAVIOR	Per Offence	Maximum[2]	Per Offence	Maximum[2]
Appropriation of …				
a PTIN			$1,000	$75,000
an EFIN			$250	None
Failure to disclose use of preparer and fees paid to preparer by taxpayer.			$500	None

[1]Taxpayers and the preparers they use must comply with the requirement of IRS Form 8867, Paid Preparers' Due Diligence Checklist for the Earned Income Credit, American Opportunity Tax Credit, Child Credit (including the Additional Child Tax Credit and Credit for other Depends) and/or Head of Household Filing status.
[2]Maximum is annual maximum per calendar year.

Digital assets

Modernize rules treating loans of securities as tax-free to include other asset classes and address income inclusion

A common transaction in the securities market is a loan of securities. Owners of securities such as pension plans, mutual funds, insurance companies and other institutional investors lend their securities because they receive compensation for doing so. Under current law, loans of securities of this kind ordinarily are treated as transactions in which no gain or loss is recognized if the transfer of a security is pursuant to an agreement that meets certain requirements under section 1058. Gain or loss also is not recognized on the return of that security in exchange for rights under the agreement. For this purpose, the term "securities" means corporate stock, notes, bonds, debentures and other evidence of indebtedness, and any evidence of an interest in or right to purchase any of the foregoing. However, the market for lending of financial and other assets has expanded over time to include new types of assets, and current law also does not address how a lender of a security that accrues interest (or other income) should take that interest (or other income) into account.

The proposal would expand the securities loan nonrecognition rules to include loans of actively traded digital assets recorded on cryptographically secured distributed ledgers, if such loans have terms similar to those currently required for loans of securities. For example, if during the term of a loan the owner of the digital asset would have received other digital assets or other amounts if the loan had not taken place, the terms of the loan agreement should provide that those amounts will be transferred by the borrower to the lender. Additionally, the proposal would require that income that would be taken into account by the lender if the lender had continued to hold the loaned asset must be taken into account by the lender in a manner that clearly reflects income. The proposal would provide for appropriate basis adjustments to the loan contract and when the loaned asset is returned. The proposal would clarify that fixed-term loans are subject to the securities loan nonrecognition rules if they would otherwise qualify.

The proposal would be effective for tax years beginning after December 31, 2023.

Provide for information reporting by certain financial institutions and digital asset brokers for purposes of exchange of information

Under current law, any person doing business as a broker is required to report certain information about its customers to the IRS, such as the identity of each customer, the gross proceeds from sales of securities and certain commodities for such customer, and, for covered securities, cost basis information. However, these rules do not adequately address transactions in digital assets, thereby permitting tax evasion. In addition, under current law, the United States may receive, as well as provide, tax information pursuant to an income tax treaty or other international information exchange agreement, including information about the identity of beneficial owners of entities. Such information is central to IRS enforcement efforts against offshore tax evasion. To ensure that the United States can benefit from a global automatic exchange of information framework with respect to offshore digital assets, the proposal would:

- Require certain financial institutions to report the account balance for all financial accounts maintained at a U.S. office and held by foreign persons,
- Expand the current reporting required with respect to U.S. source income paid to accounts held by foreign persons to include similar non-U.S. source payments,
- Require financial institutions to report the gross proceeds from the sale or redemption of property held in, or with respect to, a financial account held by a foreign person, and

- Require financial institutions to report information regarding certain passive entities and their substantial foreign owners.

When reporting with respect to digital assets held by passive entities, the proposal would:

- Require brokers to report information relating to the substantial foreign owners of the passive entities, and
- Require a broker to report gross proceeds and such other information as the Secretary may require with respect to sales of digital assets with respect to customers, and in the case of certain passive entities, their substantial foreign owners.

The proposal would be effective for returns required to be filed after December 31, 2025.

Require reporting by certain taxpayers of foreign digital asset accounts

Section 6038D requires any individual that holds an interest in one or more specified foreign financial assets with an aggregate value of at least $50,000 during a tax year to attach a statement with required information to the individual's tax return by the due date for that return. Treasury regulations under section 6038D also apply the requirements of this section to domestic entities formed or availed of for purposes of holding specified foreign financial assets. Currently, there are two general categories of specified foreign financial assets: (a) a financial account maintained by a foreign financial institution, and (b) certain specified foreign assets not held in a financial account maintained by such a financial institution. Information required to be reported includes the name and address of the financial institution where an account is maintained, the account number, as well as identifying information about assets not held in a financial account. The current rules, however, do not adequately address digital assets, and tax compliance and enforcement with respect to digital assets is a growing problem. This is especially true with respect to individuals that have offshore holdings of accounts with digital assets.

The proposal would amend section 6038D(b) to require reporting with respect to any account that holds digital assets maintained by a foreign digital asset exchange or other foreign digital asset service provider (a "foreign digital asset account"). Reporting will generally be required only for taxpayers that hold an aggregate value of all three categories of assets in excess of $50,000. A foreign digital asset account would generally be defined based on where the exchange or service provider is organized or established.

The proposal would be effective for returns required to be filed after December 31, 2023.

Amend the mark-to-market rules to include digital assets

Section 475 requires dealers in securities to use the mark-to-market method of accounting for inventory and non-inventory securities held at year end. For this purpose, a "security" includes corporate stock, interests in widely held or publicly traded partnerships and trusts, debt instruments, and certain derivative financial instruments. Dealers in commodities and traders in securities or commodities may elect to use the mark-to-market method. A "commodity" means any commodity which is actively traded, any notional principal contract with respect to any such commodity, and certain other derivative financial instruments and hedges with respect to such commodities. Mark-to-market accounting generally provides a clear reflection of income with respect to assets that are traded in established markets, and for financial accounting purposes, taxpayers may be required to mark inventory or trading positions to market, including at year-end. In addition, allowing taxpayers to use their financial accounting valuations for tax purposes may reduce tax compliance costs. However, the current mark-to-market rules do not include digital assets, many of which are actively traded.

The proposal would permit certain digital assets to be marked-to-market at the election of a dealer or trader in those assets—in particular, actively traded digital assets and derivatives on, or hedges of, those digital

assets, under rules similar to those that apply to actively traded commodities. The determination of whether a digital asset is actively traded would take into account relevant facts and circumstances, which may include whether the asset is regularly bought and sold for U.S. dollars or other fiat currencies, the volume of trading of the asset on exchanges that have reliable valuations, and the availability of reliable price quotations. A digital asset would not be treated as a security or commodity for purposes of the mark-to-market rules and would therefore be eligible for mark-to-market treatment only under the rules applicable to this new category of assets.

The proposal would be effective for tax years beginning after December 31, 2023.

Extend IRS funding

Expand mandatory funding provided to the IRS for fiscal years 2032 and 2033

The IRA provides nearly $80 billion in mandatory funding to the IRS, over a 10-year period, ending with fiscal year 2031, to supplement the agency's annual appropriations.

According to the Green Book, the IRS's operating budget fell by 18% in inflation-adjusted dollars between 2010 and 2021. Treasury and the IRS have made repeated public statements that IRA funding will be used to dramatically improve customer service, modernize decades-old computer systems, and improve enforcement with respect to complex partnerships, large corporations, and high-income individuals, all in the goal of ensuring a fairer and more efficient tax system and reducing the tax gap.

The Green Book further ruminates that long-term funding is essential for planning, especially to hire and train top talent to take on the most complex tax administration tasks, such as audits of complex partnerships and large corporations. According to the Greenbook, without mandatory funding beyond fiscal year 2031, the IRS will be confronted with an abrupt and severe decline in its budget in fiscal year 2032, and the IRS will be forced to cut back on audits of large corporations and complex partnerships and thereby increase the deficit.

The proposal would provide mandatory funding for the IRS for fiscal years 2032 and 2033 to supplement the annual appropriations. The proposal would provide $14.3 billion in fiscal year 2032 and $14.8 billion in fiscal year 2033 to continue IRA-funded enforcement and compliance initiatives and investments.

KPMG observation

Less than a year after enactment of the IRA, the administration is ensuring that the discussion as to IRS funding is raised early, and most likely often, in the years to come. Highlighting the fact that the IRS's operating budget fell by 18% in inflation-adjusted dollars between 2010 and 2021 (despite taxpayer growth and additional administrative obligations placed upon IRS during this period), the Green Book sets out the anticipated "transformational" change slated for the IRS over the next decade due to the IRA funding. General consensus exists in the broader tax community that the IRS has been challenged, and encumbered, by decreasing funding, decreasing staffing, antiquated technology, and COVID-19, while implementing TCJA, the CARES Act, and numerous other legislative changes. While the administration seeks to ensure mandatory IRS funding for fiscal year 2032 and beyond, many, particularly Congress, will be closely watching how the IRS utilizes the funding and if the IRS achieves the transformational change outlined. The Service has the next 10 years to make a case for continued mandatory funding.

KPMG contacts

Passthroughs	Deborah Fields	dafields@kpmg.com	+1 202-533-4580
Global mobility services	Martha Klasing Joan Smyth	mklasing@kpmg.com jsmyth@kpmg.com	+1 202-533-4206 +1 202-533-4404
Corporate	Mark Hoffenberg Maury Passman	mhoffenberg@kpmg.com mpassman@kpmg.com	+1 202-533-4058 +1 202-533-3775
Compensation and benefits	Robert Delgado Terri Stecher	rdelgado@kpmg.com tstecher@kpmg.com	+1 858-750-7133 +1 202-533-4830
Estates, gifts, and trusts	Tracy Stone Scott Hamm	ttstone@kpmg.com scotthamm@kpmg.com	+1 202-533-4186 +1 202-533-3095
Insurance	Sheryl Flum	sflum@kpmg.com	+1 202-533-3394
Regulated investment companies	Erik Corwin	ecorwin@kpmg.com	+1 202-533-3655
Banking	Elizabeth L'Hommedieu Matthew Mosby	elhommedieu@kpmg.com mmosby@kpmg.com	+1 614-249-1849 +1 704-371-5265
Other financial products & debt	Jon Zelnik	jzelnik@kpmg.com	+1 202-533-4193
Exempt organizations	Ruth Madrigal Preston Quesenberry	ruthmadrigal@kpmg.com pquesenberry@kpmg.com	+1 202-533-8817 +1 202-533-3985
International	Seth Green Danielle Rolfes Ron Dabrowski	sethgreen@kpmg.com drolfes@kpmg.com rdabrowski@kpmg.com	+1 202-533-3022 +1 202-533-3378 +1 202-533-4274
Mergers & acquisitions	Thomas Wessel Gordon Warnke	twessel@kpmg.com gwarnke@kpmg.com	+1 202-533-5700 +1 212-954-2458
Income tax accounting	Eric Lucas	ejlucas@kpmg.com	+1 202-533-3023
Economic & valuation services	Mark Martin	mrmartin@kpmg.com	+1 713-319-3976
Energy	Hannah Hawkins Robert Swiech	hhawkins@kpmg.com rswiech@kpmg.com	+1 202-533-3007 +1 713-319-3257
Financial institutions and products	Mark Price	mhprice@kpmg.com	+1 202-533-4364

Accounting for income taxes	Ashby Corum Jenna Summer	acorum@kpmg.com jsummer@kpmg.com	+1 313-230-3361 +1 202-533-3614
State and local tax	Harley Duncan Sarah McGahan	hduncan@kpmg.com smcgahan@kpmg.com	+1 202-533-3254 +1 713-449-9748
Excise and credits	Taylor Cortright	tcortright@kpmg.com	+1 202-533-6188
REITs	Stephen Giordano David Lee	stephengiordano@kpmg.com dwlee@kpmg.com	+1 202-533-3535 +1 202-533-4071
Practice, procedure and administration	Greg Armstrong	gregoryarmstrong@kpmg.com	+1 202 533 8816
Healthcare	Monica Coakley Lori Robbins	mcoakley@kpmg.com lorirobbins@kpmg.com	+1 615-248-5639 +1 202-533-3491

Contact us

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

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

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

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

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

www.kpmg.com

kpmg.com/socialmedia