KPMG report: Analysis and observations of tax proposals in Biden Administration's FY 2022 budget

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Introduction

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

Background

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

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

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

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

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

With that in mind, what follows in this document is KPMG's more detailed explanation of the Biden Administration's tax proposals. This analysis includes observations on what the Biden proposals might mean for taxpayers, observations on what the proposals include, and often observations on what they do not.

The fiscal year 2022 budget

On Friday, May 28, 2021, the Biden Administration transmitted its FY 2022 budget recommendations to Congress.

In the FY 2022 budget proposals, the administration laid out both its annual discretionary spending plan for the fiscal year beginning October 1, 2021, and its long-term infrastructure and social spending plans.

Those long-term plans—and tax proposals to offset their costs—were previously outlined in the "Made in America Tax Plan," the "American Jobs Plan" and "American Families Plan."

Read ***TaxNewsFlash*** and ***TaxNewsFlash***

The purported $4 trillion+ total revenue cost of the two long-term spending plans would be offset over a 15-year period by tax measures, also recommended in the budget document (read details in Treasury's **analytical perspectives** [PDF 5.2 MB] (246 pages)). Details of the tax proposals are provided by the Treasury in the Green Book.

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

Highlights of tax proposals

The tax proposals in the Biden Administration's budget for FY 2022 are generally consistent with the corporate, international, individual, and investment tax proposals in the Made in America Tax Plan, the American Jobs Plan, and the American Families Plan. There are, however, some important new details and modifications, as well as a few new proposals and one significant recommendation with regard to an effective date.

Corporate and international tax proposals

Corporate and international revenue-raising proposals include:

- Increasing the statutory corporate rate to 28%
- Imposing a 15% minimum tax on global book income of certain large corporations
- Reducing to 25% the deduction for "global intangible low-taxed income" (GILTI), eliminating the "qualified business asset investment" (QBAI) exemption, and imposing a jurisdiction-by-jurisdiction calculation
- Repealing the deduction for "foreign-derived intangible income" (FDII)
- Replacing the "base erosion anti-abuse tax" (BEAT) with a new "stopping harmful inversions and ending low-tax developments" (SHIELD) regime that would deny U.S. tax deductions for payments to foreign related parties subject to a "low effective tax rate"
- Limiting the ability of domestic corporations to expatriate by tightening the anti-inversion rules
- Restricting the deduction of interest by a financial reporting group attributable to disproportionate U.S. borrowing
- Expanding the application of section 265 to disallow deductions attributable to income exempt from tax or taxed at a preferred rate
- Denying certain deductions related to offshoring jobs
- Increasing the IRS enforcement budget
- Reforming taxation of foreign fossil fuel income
- Repealing fossil fuel subsidies
- Limiting foreign tax credits from sales of hybrid entities
- Reinstating Superfund taxes

Individual and investment-related tax proposals

Individual and investment tax proposals 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 (applicable to gains required to be recognized after the date of announcement)
- Treating transfers of appreciated property upon death or by gift with unrealized capital gains appreciation in excess of $1 million as realization events, with exclusions for donations and certain tangible personal property and deferral of gain for family-owned and operated businesses—special rules providing for spousal portability and treatment of capital gains attributable to a primary residence also would apply
- Taxing carried (profits) interest income as ordinary income
- Repealing deferral of gain from like-kind exchanges completed in tax years beginning after December 31, 2021, when greater than $500,000
- Making permanent the current limitation on excess business losses of noncorporate taxpayers
- Modifying the net investment income and Self-Employment Contributions Act (SECA) tax rules for high-income taxpayers with certain income related to pass-through entities
- Providing additional funding for tax administration to improve compliance
- Requiring financial institutions to report information on account flows

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:

- Extending the expansion of the Child Tax Credit to certain children through 2025 and making the credit fully refundable
- Making permanent the expansions to the Child and Dependent Care Tax Credit
- Making permanent the expansions to the Earned Income Tax Credit for childless workers
- Extending the expanded Affordable Care Act (ACA) premium tax credits

And the administration recommended over $300 billion (over 10 years) of tax incentives for clean energy, including:

- Extending and enhancing of renewable and alternative energy incentives
- Establishing new tax credits for advanced energy manufacturing
- Establishing tax credits for heavy and medium-duty zero emission vehicles
- Providing tax incentives for renewable aviation fuel
- Extending and enhancing energy efficiency and electrification incentives
- Providing a disaster mitigation tax credit
- Expanding and enhancing the carbon oxide sequestration credit
- Extending and enhancing the electric vehicle charging station credit

Effective dates

Congress will ultimately determine the effective dates of any tax legislation, as well as any transition and grandfather rules it deems appropriate. In most cases, the Green Book proposes that the tax changes be effective January 1, 2022 (which is how budget recommendations are ordinarily submitted). There are exceptions, however, and some are notable.

The proposal to tax long-term capital gains and qualified dividends for high-income taxpayers at ordinary rates would be effective, according to the Green Book, "for gains required to be recognized after the date of announcement." It is unclear whether the applicable date would be the date of the transmittal of the budget (that is, May 28, 2021) or the earlier date of release of the American Families Plan in April 2021. Either way, the proposal would be effective for future realizations, if Congress were to accept the administration's recommendation in enacted legislation.

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

Additionally, the proposal related to the repeal of section 1031 applicability to gains in excess of $500,000 per taxpayer would be effective for exchanges completed in tax years beginning after December 31, 2021—apparently regardless of the date upon which the exchange may have begun.

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

Revenue effects of tax proposals

The FY 2022 Biden Administration's Green Book includes tax proposals intended to have the effect of increasing net revenues in the 10-year period running from FY 2022 through FY 2031 by $2.393 trillion when compared with current law. These revenues partly offset the approximately $4.5 trillion in spending proposed in the budget. Some of the tax proposals with the largest estimated revenue effects over the 10-year budget window include:

Increase the corporate rate to 28%	$858 B
Revise GILTI	$534 B
Financial account information reporting	$463 B
Repeal BEAT and replace with SHIELD proposal	$390 B
Tax capital gains at ordinary income tax rate for high income individuals and tax unrealized appreciation at death for some estates	$323 B
Increase top individual rate to 39.6%	$132 B
Eliminate fossil fuel preferences	$35 B
Extend and modify the Child Tax Credit	-$449 B

Renewable & alternative energy tax incentives	-$265 B
Make permanent the American Rescue Plan Act of 2021 (ARPA) expansion of the health insurance premium tax credit	-$163 B
Make permanent ARPA expansion of the earned income tax credit (EITC) for childless workers	-$105 B
Make permanent ARPA changes to the Child & Dependent Care tax credit	-$104 B

The revenue estimates provided with the FY 2022 Green Book were prepared by the Treasury. Pursuant to the Congressional Budget Act of 1974, revenue estimates prepared by the non-partisan Joint Committee on Taxation (JCT) are the official estimates for tax legislation considered by Congress. Thus, if any of the proposals described in the Green Book are ultimately considered by Congress, it will be JCT estimates that govern that exercise, not the estimates provided by the Treasury.

KPMG observation

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

Additional revenue-raising proposals could be added, as well. Several proposals put forth by President Biden during the presidential campaign have not been included in the budget—such as further changes to the taxation of estates; repeal of the section 199A deduction for pass-through businesses; a 28% cap on the tax benefit of itemized deductions; a tax on the assets of financial institutions; and a modification of the income cap for payroll taxes.

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

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

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This report is organized as follows:

Contents

Corporate (in general)

Raise the corporate income tax rate to 28%

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

KPMG observation

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

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

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

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

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

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

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

KPMG observation

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

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

The proposed book minimum tax regime would permit taxpayers to claim a book minimum tax credit

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

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

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

KPMG observation

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

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

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

The proposal could motivate affected corporate taxpayers to convert deductible expenses into tax credits. For example, the proposal could make the elections to claim tax credits as opposed to tax

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

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

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

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

International

Glossary

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

Interactions of the Green Book proposals with the ongoing negotiations at the OECD on Pillars One and Two

In parallel with the release of the Green Book, the administration is actively engaged in international negotiations at the OECD to reach consensus on a two-pillar approach to reforming current agreed international tax rules and standards. The Green Book refers to the ongoing work at the OECD multiple times, and some of the international proposals are based in part on, and coordinated with, the OECD work. 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 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.

The G20 Finance Ministers and Central Bank Governors communiqué from April 7, 2021, stipulated a mid-2021 deadline for a "global and consensus-based solution" building on the OECD Blueprints for both pillars. In recent days there have been various public indications that G7 countries will strive to reach a high-level agreement on certain key elements as part of the G7's early June meetings. A G7-level agreement in June could provide significant momentum for a more comprehensive agreement later in the year at the OECD and the G20. While public reports indicate significant progress in the negotiations over the past several weeks, it remains unclear whether an agreement will be reached at the G7 in June or the OECD later in 2021.

Pillar Two interactions

Two key proposals in the Green Book—the replacement of BEAT with SHIELD and revisions to GILTI—align with and are informed by the policy objectives of the OECD work on Pillar Two, though certain of the design features vary. These proposals explicitly refer to and coordinate with Pillar Two. The current GILTI regime was an important impetus for the IIR proposed in Pillar Two. Several aspects of the current GILTI regime, however, were not included in the OECD version. Moreover, BEAT is not aligned with the UTPR proposed in Pillar Two, which acts as a backstop to the Income Inclusion Rule. Replacing BEAT with SHIELD and proposing modifications to GILTI reinforce the Biden Administration's commitment to Pillar Two and willingness to embrace and draw upon some of the design features worked out at the OECD. For example, SHIELD appears to be inspired by, and in important respects is aligned with, the Undertaxed Payments Rule, and its operation would coordinate explicitly with other countries' implementation of the Income Inclusion Rule, including by incorporating the agreed global minimum taxation rate.

The administration's proposals, if adopted, also would remove several key sticking points in the negotiations on Pillar Two and thus may increase the probability of reaching an international consensus. For example, it has been widely reported that some members of the OECD Inclusive Framework on BEPS are uncomfortable treating the current GILTI regime as a qualified Income Inclusion Rule because it allows foreign income and taxes to be globally blended, whereas the OECD Pillar Two proposal would apply a more restrictive jurisdiction-by-jurisdiction approach. The proposal in the Green Book to apply GILTI on a jurisdiction-by-jurisdiction basis would eliminate that sticking point. Indeed, the Green Book's description of its revisions to GILTI include rebranding it as a "global minimum tax," refraining from even referring to section 951A as GILTI throughout its description of the proposed revisions to that section (even though they would retain the basic structure of section 951A of relying on foreign tax credits and the section 250 deduction rather than imposing a "top-up" tax).

Furthermore, the OECD Inclusive Framework on BEPS has strongly encouraged the United States to limit the operation of the BEAT in respect of payments to entities that are subject to an Income Inclusion Rule. SHIELD, which would replace BEAT, would explicitly coordinate with other countries' implementation of the Income Inclusion Rule, potentially removing another key sticking point.

Finally, a number of countries have expressed concerns that the FDII regime represents harmful tax competition and an inappropriate export preference. The administration's proposal to eliminate FDII, if adopted, could eliminate those countries' concerns, potentially strengthening the U.S.'s negotiating position.

While the proposed changes to GILTI and the replacement of BEAT with SHIELD align more closely to the Pillar Two proposal and remove key impediments to consensus, there are a number of features of both that are different than what is outlined in the Pillar Two Blueprint. Notably, one of the proposed changes to GILTI is to remove the exemption for a deemed return on tangible assets (QBAI). This proposed change is contrary to the Pillar Two proposal, which provides an exclusion for a fixed return on payroll and tangible assets. Furthermore, while SHIELD would deny a deduction for the full amount of any payment made (or deemed made) to low-tax group members (i.e., a "cliff" mechanism), the Undertaxed Payments Rule in the Pillar Two proposal is designed to impose only enough tax to "top-up" the low-taxed income to the minimum rate. It is unclear whether these and other design differences ultimately will be aligned in further negotiations in the development of Pillar Two.

Pillar One interactions

The Green Book does not make any reference to Pillar One. On its face this is somewhat surprising given that the administration has recently presented a modified approach to Pillar One and has taken every opportunity to affirm its commitment to the OECD process and to reaching an agreement on both pillars by the mid-2021 deadline. Given that the negotiations on Pillar One are highly fluid, however, and the scope is still not agreed, the administration likely considered it premature to include a formal proposal to implement Pillar One without further progress on the basic framework.

Other interactions and effects

The administration recently signaled that it would be willing to accept a Pillar Two global minimum rate of taxation at 15%. Depending on the agreed rate for global minimum taxation, tax rates among jurisdictions (particularly above the minimum rate) will continue to vary. The possibility of a wide gap between a global minimum taxation rate set at 15% compared to the administration's newly proposed 28% corporate tax rate and 21% GILTI rate is likely among the reasons the Green Book also includes aggressive new anti-inversion provisions (as discussed in more detail below).

Transparency and reporting

Discussions regarding mandatory public country-by-country reporting (CbCR) of tax information have been a recent focus of global tax reform debates, particularly within the European Commission. During the Obama Administration, the United States implemented the OECD agreed minimum standard requiring domestic corporations to file a country-by-country tax report with the IRS that would then be shared with other tax administrations in the jurisdictions in which the businesses operated. The Obama Administration explicitly opposed public CbCR, however. While the Biden Administration has not commented officially on the current debate, the absence of any specific proposal in the Green Book may indicate that, notwithstanding European Commission pressure to the contrary, the Biden Administration is not currently breaking from the Obama Administration position. European Commission officials have

suggested that global consensus on Pillar Two will facilitate their goal of requiring public disclosure of global effective tax rates, including more broadly than EU resident corporations. The Commission's linking of Pillar Two to its broader public disclosure aspirations (and Pillar One to its goal of implementing formulary apportionment more broadly) could potentially interfere with the Biden Administration's efforts to gain the necessary political support for its global minimum taxation objectives.

Exchange of information regarding financial accounts under the Intergovernmental Agreements to Improve Tax Compliance and to Implement FATCA (the "FATCA IGAs") has also been a key development in tax transparency over the last decade. In that vein, Obama-era Green Books included a proposal to increase reporting by U.S. financial institutions with respect to foreign persons that hold U.S. accounts in order to provide reciprocal reporting under the FATCA IGAs. Although the Green Book contains limited measures to increase reporting with respect to foreign persons in order to provide reciprocity under information exchange agreements with respect to crypto assets, the Green Book does not include the other reciprocity proposals called for by the Obama Administration. That omission appears to leave gaps in the ability of the United States to deliver on its political commitment to provide reciprocal information under the FATCA IGAs.

This development is particularly surprising as the Green Book concurrently proposes increased reporting with respect to U.S. account holders, and the Biden Administration's American Families Plan Tax Compliance Agenda states that such increased reporting will also apply to foreign financial institutions. While the Biden Administration has not stated how such increased reporting would be obtained from foreign financial institutions (e.g., through changes to the statute impacting financial institutions that perform reporting under chapter 61 or through increased reporting under FATCA), a failure to follow through on comprehensive FATCA IGA reciprocity may make it more difficult to obtain additional reporting from FATCA IGA partners.

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

Revise the global minimum tax regime

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

Section 951A, commonly referred to as the GILTI regime, requires a U.S. shareholder of a CFC to include such CFC's tested income currently in its gross income regardless of whether such income is in fact repatriated to the United States. Under current law, the computation of a U.S. shareholder's GILTI inclusion is made on an aggregate basis across all of its CFCs by reducing the U.S. shareholder's pro rata share of CFC tested income by its pro rata share of CFC tested losses. Additionally, a taxpayer's GILTI inclusion is reduced by its net deemed tangible income return. That net deemed tangible income return

is 10% of a CFC's QBAI when the CFC has tested income for the year, reduced by certain interest expense taken into account in determining net CFC tested income. Further, corporate U.S. shareholders are currently allowed a deduction pursuant to section 250 equal to 50% of their GILTI inclusion, subject to an overall taxable income limitation. Any amount of a CFC's tested income that does not result in a GILTI inclusion (on account of the offset of such income that results from QBAI or a tested loss of another CFC) may result in E&P (exempt E&P) that may be repatriated to a 10% corporate shareholder without being subject to U.S. tax if the corporate shareholder qualifies for a DRD under section 245A.

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

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

Elimination of QBAI and reduction of the section 250 deduction

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

KPMG observation

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

The administration also proposes to reduce the section 250 deduction from 50% to 25%, thus generally increasing the pre-credit effective tax rate for GILTI inclusions. The combination of increasing the corporate tax rate to 28% and decreasing the section 250 deduction to 25% results in doubling the U.S. effective tax rate on GILTI from 10.5% to 21%. The administration believes that narrowing the gap between the U.S. effective rate on domestic income and GILTI inclusions

will reduce incentives to locate operations abroad. However, as recognized by the Green Book's SHIELD and anti-inversion proposals, such incentives would still remain if there is ultimately a gap between the U.S. effective rate on GILTI inclusions and the rate for any global minimum tax agreed upon through the OECD's Pillar Two project (or if no agreement on Pillar Two is reached).

KPMG observation

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

Jurisdiction-by-jurisdiction calculation

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

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

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

KPMG observation

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

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

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

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

USP, a domestic corporation, owns the stock of CFCX, a CFC with operations in country X, and CFCY, a CFC with operations in country Y. In year 1, USP, after allocating its U.S.-level expenses, has $100 of taxable income within its country X GILTI basket, and a $50 loss within its country Y GILTI basket. In year 2, USP, after allocating its US-level expenses, has $100 of taxable income within its country X GILTI basket, and $50 of taxable income within its country Y GILTI basket. Under current law, USP would combine its country X and country Y income for a total of $50 and $150 in the GILTI basket for years 1 and 2, respectively. Under the administration's proposal, USP would establish separate GILTI baskets for the country X and country Y income. In year 1, even though USP would generally calculate its inclusion and associated foreign tax credit limitation on a jurisdictional basis, USP would reduce its income within the country X basket by the $50 loss in the country Y basket under the "separate limitation loss" rules, which require a loss in one basket to be reallocated to reduce income in a basket with positive foreign source income (and then subsequently recaptured). In year 2, USP would be required to recapture the full amount of income in the country Y basket as country X income. If USP has GILTI foreign tax credits in the country Y basket in year 2, those GILTI foreign tax credits would not be recharacterized under current regulations and could be permanently lost. Further, any foreign taxes paid to country X in year 1 that were not creditable due to the reduction in country X FTC limitation on account of the application of the separate limitation loss rules to reduce foreign source income in the country X basket in year 1 on account of the country Y loss are not able to be carried forward under section 904(c). Therefore, when the separate limitation loss is recaptured in year 2, USP may not have

sufficient current year country X FTCs to reduce the U.S. federal income tax liability on the recaptured income.

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

KPMG observation

The administration's proposal does not provide specifics regarding the computation of a U.S. shareholder's jurisdictional GILTI inclusion. Under current law, tested income is calculated for each CFC; regulations provide rules for the allocation and apportionment of a CFC's deductions at the CFC-level; and regulations (adopted to implement the GILTI high-tax exception, which the administration proposes to repeal) provide rules to assign income and taxes to "tested units." It seems reasonable to assume that the proposed jurisdiction-by-jurisdiction rules would leverage this existing law and provide additional rules to calculate the aggregate tested income of entities that would not be within the same "combined tested unit" under existing law.

A U.S. shareholder would need additional guidance regarding the computation of its GILTI inclusion with respect to a given jurisdiction where the U.S. shareholder operates in such jurisdiction both through a CFC incorporated in such jurisdiction as well as through a separate disregarded entity operating in such jurisdiction that is owned by the U.S. shareholder's CFC incorporated in a different jurisdiction. For example, a U.S. shareholder that owned a U.K. CFC as well as indirectly owned a disregarded U.K. operating entity of a Dutch CFC would need additional guidance regarding the computation of its U.K. GILTI inclusion. Under the administration's proposal it appears the tested income of U.K. CFC and U.K. DRE would be combined because they operate within the same jurisdiction. However, the only combination rule contained in the existing or proposed GILTI or GILTI HTE regulations is limited to situations when multiple tested units in a jurisdiction are owned by the same CFC, rather than across CFCs. Further, more nuanced rules may be appropriate to coordinate the separate jurisdictional FTC limitation with respect to the GILTI and branch baskets when a taxpayer operates through branches and CFCs in a jurisdiction and the various operations are subject to a consolidation or loss-sharing regime in such jurisdiction.

KPMG observation

While the proposal would apply a jurisdiction-by-jurisdiction FTC limitation with respect to foreign branch income, the proposal does not appear to apply a jurisdiction-by-jurisdiction approach with respect to the calculation of taxable income from a foreign branch (i.e., foreign branch losses in Country A would not be limited to only offset income from foreign branch income in Country A in computing taxable income even though Country A would be a separate branch basket for FTC purposes). A jurisdiction-by-jurisdiction FTC limitation on foreign branch income would reduce cross-crediting and increase complexity, but the harsh timing difference issues that could lead to lost GILTI credits (as discussed above) would be less impactful to the foreign branch basket because foreign branch credits may be carried back one year and carried forward 10 years. Therefore, it may be that excess FTCs paid to country X in year 1 for which there is insufficient FTC limitation in year 1 on account of a branch loss incurred in a different jurisdiction may be utilized in a future year in which a taxpayer does have sufficient capacity. Further guidance under the proposal would be needed to clarify how losses incurred in a branch in one jurisdiction factor into the determination of the FTC limitation for income earned in branches in other jurisdictions, as well as how these losses factor into the determination of the FTC limitation in non-branch baskets. For example, if a taxpayer has income in branches located in multiple jurisdictions, presumably a loss incurred in a branch in a different jurisdiction would reduce foreign source income in each other branch jurisdiction pro rata under the separate loss limitation rules (and presumably before the separate loss limitation rules would allocate losses of a branch in one jurisdiction to income in a non-branch basket).

KPMG observation

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

The complexity of allocating and apportioning deductions would also increase. For example, interest expense and stewardship expense are apportioned among the foreign tax credit limitation baskets based on the value and character of the U.S. taxpayer's assets, including stock in a CFC. The character of CFC stock held by a U.S. taxpayer is determined under a mechanical set of rules that generally characterizes CFC stock based on the income produced by such CFC and its subsidiaries. The expansion of the number of foreign tax credit baskets to align with the jurisdictions in which a CFC earns GILTI would complicate the process of characterizing CFC stock in cases where a U.S. taxpayer owns the stock of a CFC that directly and indirectly owns CFCs that produce tested income in multiple jurisdictions.

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

Credit for foreign taxes paid under an income inclusion rule

The administration's proposal would allow a foreign-parented U.S. group that owned CFCs to take into account foreign taxes paid by the foreign parent under an IIR that is consistent with the OECD Pillar 2 agreement (if a consensus is reached) "with respect to the CFC income that would otherwise be part of the domestic corporation's global minimum tax inclusion." Such foreign taxes would be taken into account by the U.S. group on a jurisdiction-by-jurisdiction basis.

KPMG observation

The proposal does not provide details on how a U.S shareholder would "take into account" foreign taxes paid by its foreign parent under an IIR to reduce its residual U.S. tax on GILTI. In particular, if these foreign taxes are included with the U.S. shareholder's other GILTI foreign tax credits, would the 20% haircut apply? The proposal does make clear, however, that only taxes paid by the ultimate foreign parent would be considered. For example, if FP (Country X) owns FS (Country Y) owns USS, taxes paid to Country Y by FS under an anti-deferral regime (as distinct from an IIR) would not be taken into account.

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

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

904(b)(4) limit a taxpayer's deductions. Instead, both rules *generally* are taxpayer favorable: section 904(b)(4) removes deductions apportioned to a section 245A subgroup from the computation of the taxpayer's foreign tax credit limitation and the exempt asset rule reduces the amount of expenses apportioned to GILTI, thereby causing more deductions to be apportioned to the taxpayer's other section 904 baskets or to its residual U.S. source income.

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

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

KPMG observation

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

KPMG observation

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

Section 864(f) recognized that, in the case of a "worldwide affiliated group," the section 861 expense allocation rules often over-allocate U.S. interest expense to income from CFCs because CFC-level debt and interest expense is ignored when apportioning a U.S. taxpayer's interest expense. That is, the current regulations apply to treat a U.S. taxpayer as if its debt supports all of its global operations pro rata and apportions the associated interest expense to reduce the taxpayer's FTC limitation accordingly, even if operations abroad rely on their own financing and therefore are not factually financed by U.S. debt. Very generally, section 864(f) would have mitigated this result by limiting a U.S. affiliated group's U.S. interest expense apportioned to its CFCs if the CFCs were also leveraged and incurred interest expense allocable to their foreign income. The application of section 864(f) post-TCJA for taxpayers with GILTI inclusions, section 245A income, and foreign branch basket income, was not at all clear and regulations were clearly needed to implement the provision. Nonetheless, rules similar to those provided in former section 864(f) that account for CFC-level debt and interest expense in determining the amount of a U.S. group's interest allocable to CFCs would be sound tax policy irrespective of the potential application of section 265, and such rules would play an even more important role in a world in which section 265 applies.

In the FY17 Green Book, the Obama Administration recognized the importance of section 864(f) in light of proposals that would implement a per-country minimum tax on foreign income and deny deductions for interest expense allocated and apportioned to foreign earnings for which no U.S. tax was paid. Accordingly, the Obama Administration would have accelerated the effective date of section 864(f) because otherwise "taxpayers would be required to allocate a disproportionate amount of their interest expense to…various categories of foreign-source gross income than is warranted."

KPMG observation

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

CFC1 stock would be assigned to the GILTI basket. Plainly, structural changes could have a significant impact on the inclusion percentage and, consequently, the amount of deductions disallowed under section 265.

In fact, the above example serves to demonstrate a broader issue regarding the treatment of tested loss offsets as giving rise to section 245A earnings, which, under the administration's proposals, would trigger the denial of deductions under section 265. With FOGEI no longer being an exception to GILTI and with no reduction in a taxpayer's GILTI inclusion attributable to QBAI, it is hard to see why any current earnings of a CFC should be treated as giving rise to section 245A earnings that result in a full disallowance of shareholder level expenses. Rather, it seems clear that neither a tested loss CFC nor a tested income CFC that benefits from the tested losses of another CFC should be treated as generating any amount of section 245A eligible income for purposes of applying section 265 to disallow deductions for interest and stewardship expenses allocable to CFC stock. One possible mechanism for achieving this result would be to treat tested income that is offset by tested losses as PTEP (similar to the treatment under section 965 of earnings of one CFC offset by deficits of another CFC) rather than to treat such income as creating section 245A eligible earnings and profits.

Even beyond problems relating to section 245A eligible earnings and profits and the application of section 265, tested losses raise other issues relating to expense allocation and apportionment. The preambles to the Treasury decisions implementing the most recent expense allocation and apportionment rules are explicitly premised on the view that stock of a tested loss CFC should be characterized as a GILTI asset even though such CFC does not generate a GILTI inclusion due to the aggregate nature of the GILTI computation. With the apparent shift to allowing only jurisdiction-by-jurisdiction netting of tested losses and tested income under the administration's proposal, and particularly absent some additional relief from the harsh annual accounting rules in GILTI, one would now expect a much higher percentage of tested losses that will never offset GILTI inclusions at all—reducing the extent to which the GILTI regime is truly "aggregate" in nature. Just as a tested loss CFC's gross tested income would not result in section 245A eligible dividends being paid, a tested loss CFC would not generate a GILTI inclusion from its tested loss activities that is eligible for a section 250 deduction in the year of the tested loss. For this reason, a tested loss CFC arguably should not be treated as an asset generating even partially exempt income for section 265 purposes, particularly if the tested loss cannot be carried forward to offset tested income of the CFC (or another CFC in the same jurisdiction) in a subsequent year.

Even assuming the "tax exempt" rules of section 864(e)(3) do not apply, the stock of a tested loss CFC would still need to be characterized for expense apportionment purposes. Characterizing such stock as within the GILTI basket (and without, as discussed above, treating any portion of such stock as giving rise to partially tax exempt income) could be an appropriate remedy, especially in cases where such CFC's tested loss is not used to reduce the tested income of a tested income CFC within the same jurisdiction. In that case, the apportionment of deductions to the GILTI basket would generate a separate limitation loss within such basket which would be recaptured in a later year when the tested loss CFC generates a GILTI inclusion. That approach would match the U.S. shareholder's interest and stewardship deductions with respect to the CFC's stock in one year to the income generated by such stock in a later year.

The approach of characterizing the stock of a tested loss CFC as within the GILTI basket could also generate appropriate results when such tested loss is used in the year such loss is generated to reduce the tested income of another CFC in the same tax year. The section 861 expense allocation

rules apportion interest expense based upon the income generated by the taxpayer's assets. The GILTI inclusion computation aggregates the items of CFCs and would do so jurisdiction-by-jurisdiction under the administration's proposal. Together, a tested income CFC and a tested loss CFC within the same jurisdiction would generate only a GILTI inclusion for such tax year and such inclusion should bear the interest expense with respect to CFCs under fungibility principles. Thus, characterizing the stock of a tested loss CFC as within the GILTI basket would match the U.S. shareholder's interest expense with respect to such stock with the income generated using GILTI's aggregate approach.

KPMG observation

Curiously, a footnote in the proposal indicates that the proposal is not intended to create any inferences regarding current law, including whether section 265 currently applies to income for which the full section 245A deduction or a partial section 250 deduction is allowed. The suggestion that section 265 could disallow deductions allocable to dividends qualifying for the section 245A deduction appears inconsistent with existing section 904(b)(4) dealing with the treatment of deductible expenses allocable to such dividends and stock that generates such dividends.

Effective dates

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

KPMG observation

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

Subpart F

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

KPMG observation

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

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

KPMG observation

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

KPMG observation

The favorable treatment of foreign-parented groups subject to IIR rules under Pillar 2 for purposes of section 951A (i.e., by taking into account any foreign taxes paid by the foreign parent under an IIR rule), emphasized in the Green Book, would create another significant point of divergence between the GILTI regime and the subpart F regime. Absent relief, subpart F income of a CFC within a foreign-parented group that is subject to an IIR potentially could be subject to double taxation while comparable tested income of the CFC would avoid that result. The Green Book does not explain the policy behind the divergent treatment. The double-tax concern for subpart F income would be mitigated if the jurisdiction of the foreign parent adopts a coordination rule similar to section 3.2.7 of the Pillar 2 Blueprint, which would allow U.S. taxes imposed on subpart F inclusions (i.e., traditional CFC income) to be taken into account in determining the effective tax rate (ETR) of the relevant CFC's jurisdiction for purposes of applying an IIR at the foreign parent level. In effect, assuming such a coordination rule in the foreign jurisdiction, subpart F would continue to represent a claim of full taxing jurisdiction for the United States (and the foreign parent's IIR would take into account the subpart F taxes in applying its IIR), while the revised GILTI rules would—consistent with Pillar 2—cede a superior taxing right to the jurisdiction of the foreign parent.

Limit the ability of domestic entities to expatriate

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

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

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

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

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

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

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

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

KPMG observation

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

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

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

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

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

KPMG observation

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

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

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

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

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

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

KPMG observation

The proposed managed and controlled test would represent a significant departure from the standards of an inversion under current law. Under the managed and controlled test, a domestic entity acquisition could constitute a complete inversion notwithstanding that there is no actual or deemed shareholder continuity between the foreign acquiring corporation and the domestic entity. Thus, a foreign acquiring corporation that acquires a domestic entity in an **all-cash deal** could be treated as a domestic corporation under the managed and controlled test.

- **Managed and controlled test in other proposals.** The FY 2017 Green Book, the Doggett Bill, and the Durbin Bill also included a managed and controlled test. The Sanders Bill did not propose a managed and controlled test for section 7874, but that bill did propose a managed and controlled test under section 7701(a)(4) that would apply for determining the tax residence of any foreign corporation. Because the proposal in the Sanders Bill would apply without regard to whether there has been a domestic entity acquisition, that proposal would be significantly broader than the Green Book proposal. The Doggett Bill also proposed a managed and controlled test for purposes of determining tax residence.

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

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

market value of the foreign acquiring corporation with the fair market value of the entire domestic corporation, rather than just the fair market value of the acquired business. Further, even if a substantiality test is included in the managed and controlled test, it is likely that the substantiality test would incorporate the principles of the NOCD rules as well as other anti-abuse rules contained in the section 7874 regulations or the principles of the "Helen of Troy" regulations. If applied, these rules would generally increase the relative value of a domestic entity for purposes of measuring substantiality.

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

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

KPMG observation

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

Reform the taxation of fossil fuel income

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

The proposal also amends the regulatory "dual capacity taxpayer" rules. Under section 901, a taxpayer

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

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

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

Factors in the formula are:

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

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

The proposal would eliminate the facts and circumstances method and codify the safe harbor method for a dual capacity taxpayer to determine the portion of a foreign levy paid for a specific economic benefit. The proposal is ambiguous regarding whether a dual capacity taxpayer operating in a foreign country without a generally applicable corporate income tax would be disallowed a foreign tax credit for the entire levy, as included in prior legislative proposals and Senator Wyden's recent proposal. The Biden proposal states that it would "codify" the existing regulatory safe harbor, which would allow creditable foreign taxes based on the U.S. rate if the local jurisdiction does not have a generally applicable corporate income tax. Nevertheless, the Green Book describes the current regulatory safe harbor and the proposal itself only in terms of allowing tax credits based on the generally applicable local corporate tax rate.

Similar to the current regulations, the proposal provides that any such rule for determining the amount of a foreign levy paid by a dual capacity taxpayer that qualifies as a creditable tax would not apply to the extent that it conflicts with any U.S. treaty obligation that specifically allows a credit for taxes paid or accrued on certain oil and gas income. Income tax treaties between the United States and the Netherlands, Norway, and the United Kingdom include relevant oil and gas extraction income tax credit provisions. For further context, it should be noted that Senator Wyden's proposed legislation also

maintains the exception for treaty overrides.

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

KPMG observation

The current dual-capacity taxpayer rules are of general applicability. To date, the rule has most commonly been of relevance to the oil and gas industries (as well as other natural resources). As such, the codification of the safe harbor method is described in connection with other reforms to the taxation of fossil fuels but appears to apply to all taxpayers. In this vein, the Green Book notes that oil and gas companies have tended to obtain the most benefit from using the facts and circumstances method instead of the safe harbor methodology. Accordingly, the proposal would generally limit the creditability of a foreign levy that, under current law, a dual-capacity taxpayer could establish under relevant facts-and-circumstances is a "tax" in its entirety and not payment for a specific economic benefit. In addition to impacting oil and gas companies, the Green Book proposal could be of significance to a taxpayer operating in a different industry in the future to the extent levies imposed on such taxpayer include an amount in respect of a specific economic benefit. In contrast, while Senator Wyden's dual capacity proposal also removes the facts and circumstances method, the proposal limits the change to "major integrated oil companies" within the meaning of section 167(h)(5).

KPMG observation

Treasury estimates that the dual capacity taxpayer proposal raises $1.43 billion in revenue over the next 10 years. This amount is much less than the "score" for prior dual capacity taxpayer proposals and likely reflects the impact of the "jurisdiction-by-jurisdiction" approach to section 904 for the GILTI and branch baskets, discussed elsewhere in this report (in addition to changes in the U.S. tax rates).

KPMG observation

In November 2020, Treasury and the IRS announced proposed foreign tax credit regulations (the "2020 Proposed FTC Regulations"). Those proposed regulations did not make any changes to the current dual capacity taxpayer regulations; however, Treasury and the IRS specifically requested comments on whether such changes were necessary. Although the proposal's modifications to the dual capacity taxpayer rules would apply to tax years ending after December 31, 2021, Treasury and the IRS could include changes to the dual capacity taxpayer regulations that eliminate the facts and circumstances method prior to the proposal's effective date when finalizing the 2020 Proposed FTC Regulations.

Repeal the deduction for foreign-derived intangible income

The administration's proposal would repeal the deduction for foreign-derived intangible income (FDII), effective for tax years beginning after December 31, 2021. The proposal would redeploy the revenue

raised by repealing FDII to directly incentivize research and development (R&D) in the United States but does not include a specific proposal for the enhanced R&D incentive.

KPMG observation

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

The Green Book justifies repeal, in part, on the grounds that FDII "perversely creates undesirable incentives to locate certain economic activity abroad." While the current-law reduction of FDII benefits for QBAI that is the focus of the Green Book's complaint can in some circumstances create an incentive for shifting operations outside of the U.S., relying on that point to repeal FDII in its entirety ignores the fact that the overall FDII regime was explicitly intended to counteract the incentive for offshoring created by the favorable treatment available for offshore income under the GILTI regime which is reduced but not eliminated by the Green Book proposals.

The Green Book also justifies repeal on the grounds that FDII only provides benefits to exporters, as opposed to domestic corporations with primarily domestic sales. The implication is that any future R&D incentive would benefit companies without regard to the market for their products. In contrast, Senator Wyden's Framework would retain FDII, but would replace "deemed intangible income" with a new metric based on a percentage of qualifying expenditures for domestic "innovation-spurring activities," such as U.S. R&D and worker training. Thus, like the administration's proposal, Senator Wyden's Framework would shift the focus from rewarding companies with excess returns from existing intangibles to direct R&D incentives for new development activities. Unlike the administration's proposal, however, Senator Wyden's Framework would still provide a benefit to exporters relative to their purely domestic peers, by providing that the share of such expenditures that would qualify for the FDII benefit would be determined by reference to the portion of the taxpayer's sales that serve foreign markets.

The proposal would repeal FDII for tax years beginning in 2022, without providing any transition relief for long-term transactions entered into in prior years. This differs from the approach taken in the repeal of two prior export incentive regimes, the foreign sales corporation (FSC) regime and the exclusion for extraterritorial income (ETI). The rules repealing the FSC and ETI regimes applied to *transactions* entered into after specified dates in recognition that some taxpayers may have negotiated long-term deals in reliance on the incentive provisions.

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

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

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

Taxpayers subject to SHIELD

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

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

KPMG observation

As discussed in further detail below, SHIELD does not build on the BEAT infrastructure in any significant way. While the $500 million revenue threshold for applying SHIELD may appear similar to the BEAT's gross receipts threshold at first glance, the proposed scope of SHIELD is drastically broader than BEAT. BEAT applies to corporate taxpayers with average aggregate annual gross receipts of at least $500 million (determined under U.S. tax principles, over a three-year period, counting only gross receipts of the group that are subject to U.S. federal income tax), and a "base erosion percentage" in excess of 3% (2% for affiliated groups containing certain financial institutions). SHIELD, by contrast, applies to any financial reporting group with a minimum degree of U.S. presence and greater than $500 million in *global* consolidated revenue for financial statement purposes. The elimination of the base erosion percentage threshold and the focus on worldwide revenue rather than U.S. revenue would dramatically broaden the scope of taxpayers potentially covered by SHIELD relative to the BEAT. It is worth noting as well that the revenue threshold under SHIELD does not appear to allow for smoothing over multiple years, consistent with the Pillar Two approach. Accordingly, it may be the case that a taxpayer may trip into and out of SHIELD if a year is atypical or if global revenue fluctuates from year-to-year given the nature of its business.

KPMG observation

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

Conditions for applying SHIELD

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

"Low-taxed" members

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

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

KPMG observation

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

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

legislation either at the outset or by future amendment.

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

KPMG observation

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

KPMG observation

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

KPMG observation

The SHIELD ETR is computed by dividing "taxes paid or accrued" by "income earned," determined based on financial statements. While "income earned" is defined to refer to financial statement income, rather than taxable income, it is less clear whether "taxes paid or accrued" relies on financial accounting concepts (in which case "taxes paid or accrued" could include, for example, deferred tax liabilities and taxes accrued for uncertain tax positions) or tax accounting concepts such as those found in section 901. The latter interpretation appears to be the better read, however, given that the proposal would provide authority to develop rules to address timing differences, which would not be necessary if the administration intended for "taxes paid and accrued" to include deferred tax items. Notably, Pillar Two allows for a slightly wider range of creditable taxes than section 901. Note also that the grant of regulatory authority in the proposal does not indicate whether the SHIELD ETR calculation is intended to align with Pillar Two on the treatment of permanent differences, temporary differences, or NOLs.

KPMG observation

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

IIR or CFC rule. The proposal would provide that a financial reporting group member's ETR is determined based on "income earned" and "taxes paid or accrued *with respect to* the income earned in that jurisdiction by financial reporting group *members*" (emphasis added). The use of the plural "members," the absence of modifying language to otherwise restrict the reference only to same-jurisdiction members, and the reference to taxes paid "with respect to income earned in that jurisdiction" (rather than, e.g., taxes paid in that jurisdiction) all suggest that taxes paid by a parent with respect to that income would be included. In addition, failing to take into account taxes under an IIR would be directly contrary to the stated objective of SHIELD to provide an incentive for other countries to adopt the IIR.

KPMG observation

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

Payments by a domestic corporation or branch

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

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

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

KPMG observation

SHIELD's application on the basis of gross payments (whether or not deductible) would deviate from the approach in the OECD's UTPR, which looks to the amount of net intercompany payments when applying its indirect payment rule. Moreover, the proposal does not indicate that any exceptions would apply based on the type of payment. The description of current law specifically mentions the exception under the BEAT regulations for total loss-absorbing capacity (TLAC) securities, suggesting that Treasury may not intend to include such an exception for purposes of SHIELD. The status of other limited exceptions provided by the BEAT, such as for qualified derivatives and services that are eligible for the services cost method, is also unclear. Indeed, if read very broadly, the term "payments" could even include dividends or other non-deductible payments made in respect of a taxpayer's own equity (although it is hard to believe this result is intended).

KPMG observation

A footnote provides that SHIELD would also take into account, in the same manner as deductible payments, reductions in gross amounts of premiums and other consideration on certain insurance, reinsurance, and annuity contracts.

KPMG observation

While the text of the proposal suggests that SHIELD could apply to U.S.-parented groups, the language in the "Reasons for Change" introductory section strongly implies that payments to CFCs that are includible in a U.S. shareholder's subpart F or GILTI income would be exempt from SHIELD. If there is such an exemption, presumably SHIELD would only exempt an amount of the payment *to the extent* that it is taken into account in determining a U.S. shareholder's pro rata share of income under subpart F or increases a U.S. shareholder's pro rata share of tested income with respect to the CFC under GILTI. The final section 267A regulations for hybrid transactions provide a similar exception. Even without an explicit exception, setting the minimum rate for SHIELD at the same rate as GILTI also suggests that U.S.-parented groups generally would not be denied deductions for payments to CFCs under SHIELD, except to the extent that book-tax differences at the CFC level made the income appear low-taxed. Note, however, that the proposal appears to take into account only taxes paid by members of the financial reporting group, so GILTI or subpart F taxes paid by an unrelated U.S. shareholder may not be taken into account for this purpose.

KPMG observation

Read literally, the proposal suggests that SHIELD could apply to payments between domestic entities. Specifically, and possibly to avoid treaty discrimination issues, the proposal does not state that a low-tax member must be foreign. Indeed, the proposal would provide authority for Treasury to exempt payments *to domestic and foreign* investment funds, pension funds, international organizations, or non-profit entities, which implies that payments to domestic members of the

financial reporting group generally are in scope. Presumably, the statutory language or future regulations promulgated thereunder would (and should) disregard payments made between members of the same U.S. consolidated return group for purposes of SHIELD. For payments between domestic business entities that are members of the same financial reporting group but not the same U.S. consolidated return group, the proposal's description leaves open the possibility that such gross payments could be taken into account. Indeed, because of the Indirect Payments Rule described above, payments between domestic members of the financial reporting group could be treated as payments to a low-taxed group member even if the U.S. income of the group is not low-taxed. In other words, if there is any low-taxed income in the group, domestic-to-domestic payments would be treated as made in part to low-taxed members. Moreover, because the SHIELD ETR is calculated based on financial accounting income, book-tax differences could cause members of the U.S. group to be low-taxed, though as noted above, Treasury would have regulatory authority to address book-tax differences, including NOLs.

KPMG observation

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

KPMG observation

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

KPMG observation

SHIELD's Indirect Payments Rule is a notable expansion of the indirect payment rule in the OECD's UTPR. Like the OECD's UTPR, SHIELD would not require taxpayers to trace through chains of payments, the methodology applied under the imported mismatch rules for hybrids in OECD BEPS Action 2 and the section 267A regulations. Unlike the UTPR, however, SHIELD's Indirect Payments Rule would apply even if the low-taxed members of the financial reporting group do not actually receive *any* payments from *any* member of the financial reporting group. For example, while the

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

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

KPMG observation

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

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

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

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

required to determine which deductions are treated as denied and for what purposes.

KPMG observation

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

KPMG observation

While the SHIELD ETR framework is not fully developed in the proposal, it seems implicit that members in a "loss jurisdiction" (based on the group's financial statements) generally would not be treated as low-taxed members. Accordingly, losses incurred by a member that, in a typical year, would be considered a "low-taxed" member may not be taken into account in the numerator of the financial reporting group's low-taxed profits ratio under the Indirect Payments Rule. If the rule operates that way, the low-taxed profits ratio would not take into account the losses when computing the numerator of the ratio, but those losses may be taken into account when computing the denominator. As noted above, Treasury would be granted authority to account for NOLs, which could allow Treasury to address this issue.

Special payment exemption categories

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

KPMG observation

While the scope of exceptions proposed to be delegated to Treasury's rule-making authority under SHIELD broadly matches the exceptions contained in the OECD Pillar Two proposal, the list of potential exempt recipients under SHIELD does not include governmental entities. The proposal does not elaborate on the reason for that apparent departure from the OECD Pillar Two approach.

KPMG observation

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

Delayed effective date

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

KPMG observation

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

Significant revenue projected

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

KPMG observation

The revenue estimate for SHIELD is massive, making it one of the largest revenue raisers among the administration's tax proposals, and bolstering the case from a revenue perspective for replacing BEAT with SHIELD. The assumptions relied on in computing the revenue estimate for SHIELD (including, e.g., the rate at which it would apply and whether potential widespread adoption of IIRs in response to the incentives created by SHIELD are taken into account) are unclear. As a general matter, revenue estimators consider anticipated changes in taxpayer behavior but assume continuation of current U.S. law. While unclear, they may feel compelled to make the same assumption regarding foreign law.

Limit foreign tax credits from sales of hybrid entities

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

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

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

KPMG observation

When Congress enacted section 338(h)(16) in 1988, it expressed concern that income from the sale of stock otherwise would be treated as foreign source income for foreign tax credit purposes, even though no foreign country likely would assert taxing jurisdiction over the income (*e.g.*, foreign

countries would view the transaction as a sale of stock by a non-resident seller). By extending the principles of section 338(h)(16) to sales of specified hybrid entities and entity classification changes not recognized for foreign tax purposes, the proposal similarly would result in items of income or loss originating from a transaction that likewise avoids tax in the local jurisdiction being treated as originating from a sale of stock for foreign tax credit purposes, thus generally resulting in U.S. source passive income (or foreign source passive income if the owner of the hybrid entity is a CFC).

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

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

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

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

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

KPMG observation

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

subsidiaries (i.e., CFCs) that the U.S. parent owns directly or indirectly.

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

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

KPMG observation

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

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

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

Because it is not realistic for a multinational corporation to continually adjust the capital structures of its members to account for such fluctuations, Treasury, and ultimately Congress, might want to consider a more stable measure to assess proportionality, such as relative assets, as under the version of proposed section 163(n) that was considered in the Senate and the asset-based methodologies for allocating interest expense under current law in Treas. Reg. §§ 1.861-9 and 1.882-5. In this regard, the OECD BEPS Action 4 Report (paragraph 118) noted that an asset-based approach could be more favorable when members of a group incur losses. In addition, we note that

both the House and Senate versions of proposed section 163(n) and the BEPS Action 4 Report (paragraph 139) did not require such strict proportionality, allowing instead for a company to deduct up to 110% of its proportionate share of the group's net interest expense, in each case as determined under the relevant measure of proportionality. The BEPS Action 4 Report acknowledged that this uplift would reduce the impact of constraints that could preclude a group from being able to precisely align its net interest expense and EBITDA ratios even in the long-term.

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

KPMG observation

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

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

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

KPMG observation

Although the proposal expressly contemplates that "excess limitation would be converted into a proportionate amount of excess limitation for U.S. tax purposes and carried forward *as set forth*

below," the proposal then fails to take the topic back up and explicitly address the duration of any such carry forward. By comparison, the Obama-era proposal provided for an indefinite carry forward of disallowed net interest expense and a three-year carryforward for excess limitation. The language describing the three-year carryforward was inexplicably struck from the description of the new proposal without providing an alternative carryforward period. Query whether the intention was to provide for an indefinite carryforward, to eliminate the carryforward entirely, or something else.

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

KPMG observation

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

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

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

KPMG observation

The proposal may beget a lot of complexity in its implementation in various contexts. Unless the regulatory authority for coordination is exercised with a conscious effort to ease compliance burdens where appropriate, the application of this proposal together with other provisions limiting the deductibility of interest could make compliance remarkably complex with arguably little

incremental benefit to the government from that complexity. For example, in the case of a foreign-parented group with one or more CFCs owned directly or indirectly by a U.S. corporation (i.e., a U.S. sandwich structure), a broad panoply of provisions that limit interest expense would be implicated and likely would apply in this order:

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

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

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

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

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

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

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

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

The administration's proposal would create a new general business credit equal to 10% of eligible expenses incurred in connection with "onshoring" a trade or business, which requires reducing or

eliminating a line of business conducted outside the United States and increasing U.S. jobs by starting up, expanding, or otherwise moving the same line of business to the United States. Expenses eligible for the U.S. tax credit would include expenses incurred by a foreign affiliate related to the onshoring. The U.S. Treasury would reimburse U.S. territories for credits provided to their taxpayers.

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

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

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

KPMG observation

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

KPMG observation

This proposal generally is consistent with an Obama Administration FY 2016 Green Book proposal with two major differences: (1) the credit is decreased from 20% to 10%; and (2) the current proposal provides for reimbursement to the U.S. territories for their costs of providing a substantially similar credit, either automatically by operation of a mirror code provision (such as in Guam or the U.S. Virgin Islands) or by separate enactment of a similar provision in a territory (such as Puerto Rico) that does not have a mirror code tax system. The Obama proposal was translated into legislative text in The End Outsourcing Act, S. 234, 115th Cong (2017), which may provide insight into how the proposal would work. That bill clarified that a business relocation could straddle tax years and defined "eligible expenses" narrowly as amounts deductible under section 162 (exclusive of employee severance), as well as permit and license fees, lease brokerage fees, and equipment installation costs.

KPMG observation

While the credit for "onshoring" would always be granted to the U.S. taxpayer that is "onshoring" jobs and would always equal 10% of the eligible expenses (whether incurred by the U.S. taxpayer or by a CFC), the tax cost of expenses associated with "offshoring" jobs could depend on which entity incurred those expenses. For example, if the CFC to which jobs are "offshored" otherwise

earns tested income under section 951A, the U.S. tax cost of disallowing the CFC's deductions would be 21% (or potentially even less if the deduction disallowance also permitted the absorption of otherwise excess foreign tax credits). The disallowance of "offshoring" expenses by the U.S. taxpayer itself seems much more likely to result in a full 28% tax cost.

KPMG observation

The narrow definition of eligible expenses under the current proposal is reinforced by Treasury's estimate of its revenue impact over the 10-year budget window: the disallowance of deductions is expected to raise just $112 million, while the expenditure for the credits is estimated to cost only $112 million.

KPMG observation

Biden's campaign plan also included a separate, potentially more impactful proposal to impose a surtax on *profits* from so-called "roundtripping," which appears to have been eliminated. That proposal would have imposed a 30.8% tax on profits earned abroad by companies that offshored manufacturing and service jobs in order to sell goods or services back to the U.S. market.

Housing and infrastructure

Expand the low-income housing tax credit

The administration's proposal would create an additional type of low-income housing credit dollar amount (HCDA) allocated to each state, the District of Columbia, and each U.S. territory (State) called the opportunity housing credit dollar amount (OHCDA). State housing credit agencies (HCAs) would have a separate ceiling for OHCDAs from their existing allocation ceilings of HCDAs. HCAs would continue to receive annual HCDAs, without change to the allocation and ceilings for those HCDAs under current law.

HCAs would be required to allocate the majority of their OHCDAs to projects in Census Tracts of Opportunity (CTOs). A CTO is a tract entirely in one or more difficult to develop areas (DDAs) or which has low poverty or other advantages as determined by the Secretary of the Treasury in consultation with HUD. A DDA is an area designated by HUD as an area that has high construction, land, or utility costs relative to area median gross income.

In each calendar year 2022 through 2026, the aggregate number of new OHCDAs would be 118% of the aggregate annual number of new HDCAs under current law. These additional OHCDAs would be made available to all States on a per capita basis, but with a different per capita amount applied to each State. The per capita amount for a State would be determined by a formula established by the Secretary in consultation with the Housing and Urban Development agency (HUD) that provides higher amounts to states with higher costs of constructing and operating affordable housing, (i.e., larger populations living in DDAs or higher percentages of rent-burdened households).

Buildings in DDAs that receive allocations of either HCDAs or OHCDAs would receive an increase in eligible basis (i.e., "basis boost") of up to 50%.

The proposal would be effective for calendar years beginning in 2022.

KPMG observation

OHCDAs would increase affordable housing in low poverty neighborhoods. The administration's reason for this change is that many HCDAs are concentrated in projects in high-poverty areas, a practice that tends to increase concentrations of poverty in the community, as well as limit the social mobility of tenants and their families. Also, while HCDAs are based upon population, OHCDAs would take into account differences among States such as average rent burden or the costs of providing affordable rental housing.

Neighborhood homes investment tax credit

The administration's proposal would create a new tax credit—the Neighborhood Homes Investment Credit (NHIC)—for existing homeowners' costs relating to new construction for sale, substantial rehabilitation for sale, and substantial rehabilitation. The constructed or rehabilitated residence must be a single-family home (including homes with up to four dwelling units), a condominium, or a residence in a housing cooperative.

For 2022 through 2031, NHICs would be allocated to the 50 States, the District of Columbia, and U.S. possessions ("State"). The amount for 2022 would be $2 billion, and this amount would be indexed for inflation for years 2023 to 2031. The Secretary would establish rules to divide the potential NHICs among the States; identify distressed neighborhoods; and establish criteria for which NHICs may be earned in certain additional rural communities and/or in gentrifying census tracts for owner-occupied rehabilitation.

Each State would create a new agency (or identify a pre-existing agency) to serve as the Neighborhood Homes Credit Agency (NHCA), with authority to allocate potential NHICs to project sponsors. Sponsors seeking potential NHICs would apply on a competitive basis by providing candidate plans for construction or rehabilitation, generally in one or more NHIC-Qualified Neighborhoods. The NHCA would be responsible for monitoring compliance with all provisions governing NHICs and for reporting violations to the Internal Revenue Service (IRS). Each NHCA would establish a qualified allocation plan (QAP) to guide it in allocating potential NHICs among competing proposals.

A taxpayer could claim NHICs only after construction, inspection, and owner occupancy. In the case of a home to be sold to a qualifying new, purchasing owner-occupant, the credit would be claimed when that owner-occupant begins residence. In the case of continuing qualifying owner-occupants who are rehabilitating their homes, the credit would be claimed when construction has been completed and inspected and the owner-occupant is in residence.

NHIC-Qualified Owners generally would be owner/occupants whose household income does not exceed 140% of area/state median income, adjusting for household size as determined by HUD.

Generally, the amount of the credit would equal development costs less the sales price, or, in the case of a homeowner rehabilitation, less the amounts paid by the homeowners for the residence. If within five years from the date of qualification for the NHIC, the purchasing or rehabilitating owner/occupant ceases to be the residence's owner occupant (i.e., the residence is sold or exchanged), a portion of the NHIC

would have to be repaid.

The proposal includes certain principles in determining the amount of credit including:

- Necessity: When sales proceeds meet or exceed development costs, no credit may be claimed.
- Limited subsidy: The credit may not exceed 35% of the lesser of: (i) development costs or (ii) 80% of the national median sales price for new homes, nor may it exceed the excess of development costs over sales proceeds.
- Skin in the game: The taxpayer must have an incentive to sell the residence for a higher sales price.
- No cliffs: There is no point at which an additional dollar of sales proceeds can precipitously reduce the credit to zero. Instead, the credit phases out such that it reaches zero at the maximum amount of permitted sales proceeds.

The proposal would apply to allocations of NHICs in calendar years after 2021. Credits could be claimed in tax years ending after December 31, 2021.

KPMG observation

The NHIC would provide a new federal tax credit that supports building or renovating owner-occupied housing. The NHIC would be allocated and administered under rules similar to the allocation and administration of the low-income housing credit.

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 federally subsidized state and local bonds for infrastructure

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

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

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

Proposal: QSIBs and transportation bonds

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

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

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

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

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

KPMG observation

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

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

Clean energy

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, 2021.

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 reference price of oil published by the Treasury exceeds a 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. While the credit was phased out for calendar years 2019 and 2020, it is expected to be available again for calendar year 2021. If post-COVID oil prices remain low, the repeal of the EOR credit could have a significant impact on oil and gas producers.

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, 2021.

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. For the 2020 calendar year, the credit amount is estimated to be approximately $0.60 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, 2021.

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. The 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, 2021.

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, 2021.

Generally, section 469 denies taxpayers the ability to deduct losses from passive activities. Where 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 where 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, 2021.

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

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 integrated oil and gas producers for tax years beginning after December 31, 2021.

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 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, 2021.

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, 2021.

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 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 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 begs 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, 2021 from royalties received on the disposition of coal or lignite ore.

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 were 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 be effective for tax years beginning after December 31, 2026.

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.

Oil Spill Liability Trust Fund excise tax exemption for crude oil derived from bitumen and kerogen-rich rock

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, 2021.

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 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.

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, 2021.

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.

Reform Taxation of Foreign Fossil Fuel Income

See discussion of proposal in the **International section** of this report.

Extend and enhance renewable and alternative energy incentives

Wind energy

Under current law, a taxpayer has to begin construction on an onshore wind facility by December 31, 2021 to qualify for the production tax credit ("PTC"). The credit rate for onshore wind facilities is in the process of phasing down and the full PTC rate is only available for projects that began construction prior to 2017. Projects that begin construction in 2017 are eligible for 80% of the otherwise eligible PTC rate. Projects that begin construction in 2018 are eligible for 60% of the otherwise eligible PTC rate. Projects that begin construction in 2019 are eligible for 40% of the otherwise eligible PTC rate. Projects that begin construction in 2020 or 2021 are eligible for 60% of the otherwise eligible rate.

A taxpayer may elect the investment tax credit (ITC) in lieu of the PTC for wind facilities, but the ITC rate phases down on a schedule comparable to the PTC.

A taxpayer that begins construction on an offshore wind farm after 2016 and before 2026 is eligible to claim an ITC at the full statutory credit rate or 30%.

Solar energy

Under current law, a taxpayer that begins construction of a solar energy facility in 2020-2022 is eligible for a 26% ITC credit. Further, a taxpayer that begins construction of a solar energy facility in 2023 is eligible for a 22% ITC. Projects that begin construction after that or that are placed in service after 2025 are eligible for a 10% ITC.

Other renewables

The PTC is available for geothermal, biomass, trash combustion, landfill gas, hydropower and wave, tide power if construction of the project begins prior to 2022.

As with wind facilities, taxpayers may elect the ITC in lieu of the PTC.

Further, fuel cell powerplants, fiber optic solar property, waste energy recovery property and small wind projects qualify for a 26% ITC rate if construction begins in 2021 or 2022, and a 22% ITC rate if construction begins in 2023. No credit is available for projects that are not placed in service by the end of 2025 or that begins construction after 2023.

Finally, there is a 10% ITC for combined heat and power property, microturbines and geothermal heat pumps that applies if construction begins prior to 2024.

Residential energy efficient property

For individuals, a credit is available for the cost of solar electricity property, solar water heating property, fuel cell property, small wind energy property, geothermal heat pump property and biomass fuel property installed in a residence. The current credit rate is 26% for property placed in service in 2021 and 2022. The rate is scheduled to phase down to 22% in 2023 and the credit is unavailable thereafter.

Proposal

Under the administration's FY 2022 Proposal, the PTC would be available for otherwise PTC-eligible projects if they begin construction after 2021 and before 2027, and the full PTC rate would be available. For projects that begin construction after 2026, the PTC rate for eligible facilities would phase out over five years, reduced by 20% each year.

The proposal would restore the ITC for projects that begin construction after 2021 and before 2026 at their full statutory rate. For projects that begin construction after 2026, the ITC rate for eligible property would phase out over five years, reduced by 20% each year.

Starting in 2022, the proposal would expand the ITC to include stand-alone energy storage technology that stores energy for conversion into electricity and has a capacity of not less than five kilowatts.

Taxpayers could elect a direct pay option in lieu of the PTC or ITC.

The proposal states that the administration will "work with Congress on measures to pair these credits with strong labor standards, benefiting employers that provide good-paying and good-qualify jobs."

The credit for residential energy efficient property would also be extended to its full statutory rate for property placed in service after 2021 and before 2026, The proposal would also expand the definition of

eligible property to include qualified battery storage technology of at least three kilowatts of capacity installed in a residence. For projects that are placed in service after 2026, the ITC rate for eligible property would phase out over five years, reduced by 20% each year.

The proposal would be effective after 2021.

KPMG observation

The administration's proposal would significantly enhance and simplify the ITC and PTC. Most significantly, the proposed direct pay option could change the landscape for developing and financing renewable energy facilities. In many cases, developers of these projects do not have sufficient tax liability to use the available tax credits and must rely on tax equity investors. Tax equity structures are complicated and there is a limited pool of investors so the direct pay option could remove barriers and simplify development for many projects.

The proposal does not provide much additional detail on how direct pay would operate. Direct pay raises various questions, including but not limited to the following:

- Whether there would be a pre-approval or other validation requirements, similar to the 1603 cash grant in lieu of tax credit program enacted under the American Recovery and Reinvestment Act of 2009.
- Whether the election and payment would be made at the partnership level, which would simplify the availability of the payment for projects owned by partnerships (but also potentially raise questions about the appropriate partnership tax treatment of the payment).
- Whether the proposal would impact the applicability of the passive activity and at-risk rules, which currently limit the benefit of PTCs and PTCs to individual investors.

In addition, the effective date of the proposal is unclear. As described, ITC and PTC eligibility is generally dependent on the date construction begins, however, the proposal just states it is "effective after 2021." It is unclear, for example, whether the proposal is intended to be effective (and direct pay available) for projects placed in service after 2021, even if currently under construction.

A direct pay option for the PTC and ITC and other credits is also featured in recently introduced legislation and appears to be a consistent feature of the administration's and Democratic lawmakers' infrastructure agenda.

Provide a tax credit for electricity transmission investments

The administration's FY 2022 proposal includes a new 30% ITC for high voltage transmission lines and associated equipment meeting certain criteria, specifically a minimum voltage of 275 kilovolts and a minimum transmission capacity of 500 megawatts. Under the proposal, taxpayers could elect a direct pay option in lieu of the tax credit. The proposal indicates that the administration will work with Congress to pair the credits with strong labor standards.

The proposal would be effective for property placed in service after December 31, 2021, and before January 1, 2032.

KPMG observation

Transmission lines and associated equipment are often owned by regulated utilities so this proposal could raise issues related to how to structure investment in, and ownership of, these assets in order to best realize the benefit of the credit. For instance, regulated utilities are subject to the normalization rules which require regulated utilities to spread the benefit of investment tax credits and accelerated depreciation over the useful life of an asset. The normalization rules are intended to allow utilities to use the economic benefit of the tax incentives to make additional investments, rather than immediately pass the benefits on to ratepayers. It is argued, however, that the rules often have the effect of making it less cost effective for utilities to make their own ITC eligible investments in comparison to unregulated entities. This proposal does not include an election to opt out of normalization, which could have made this incentive more meaningful for many regulated utilities. A similar credit proposed in Chairman Wyden's "Clean Energy for America Act" does include a normalization opt out.

Provide allocated credit for electricity generation from existing nuclear power facilities

The administration's FY 2022 proposal includes a new allocated production tax credit for electricity produced from existing nuclear power facilities. The proposal describes a competitive application process under which facilities would apply for an allocation of credits based on, among other factors:

- Demonstration of a good operation and safety record,
- Demonstration that the facility is facing financial operating losses and that future projections include continued losses, and
- Demonstration that emissions of various air pollutants would increase if the facility ceased operations.

A credit allocation round would be held every two years and up to $1 billion in credits would be to available to be allocated in each year. Under the proposal, taxpayers would also have to identify the amount of credit per megawatt-hour of generation that would be sufficient for them to continue operations during that two-year period.

Under the proposal, taxpayers would be able to elect to receive a cash payment in lieu of a tax credit through a direct pay mechanism.

The proposal indicates that the administration would work with Congress to pair the credits with strong labor standards.

If enacted, the proposal would be effective after December 31, 2021. The first two-year crediting window would commence on January 1, 2022, and the last crediting window would commence on January 1, 2030.

KPMG observation

Under current law section 45J provides an allocated credit for production from new nuclear capacity, while this proposal is intended to incentivize the continued operation of existing nuclear facilities. The mechanics of this credit proposal, while obviously carefully and specifically tailored to meet its intended purpose, could prove difficult to implement because of the frequent allocation rounds and specific eligibility determinations.

Establish new tax credit for qualifying advanced energy manufacturing

The administration's FY 2022 proposal would extend and expand the qualified advanced energy property (QAEP) credit.

The QAEP credit under section 48C is a 30% investment tax credit that is available for the construction, re-equipping, or expansion of a manufacturing facility that constructs QAEP. Included in the definition of QAEP is property such as solar, wind and other renewable energy component property, electric grids, carbon dioxide capture and sequestration property, and plug-in electric vehicles and component parts, among other eligible property. QAEP credits were first enacted as part of the *American Recovery and Reinvestment Act of 2009,* and $2.3 billion in QAEP credits were originally authorized. All of the credits were allocated by Treasury in two separate allocation rounds.

The administration's FY 2022 proposal would modify the section 48C credit by authorizing $10 billion in additional credits and expanding the eligibility criteria. Under the proposal, investments in additional categories of projects such as certain industrial facilities, recycling equipment, and energy storage would now qualify for the credit. Of the $10 billion in additional credits, $5 billion would be specifically allocated to projects in coal communities.

Under the proposal, taxpayers would be able to elect to receive a cash payment in lieu of a tax credit through a direct pay mechanism.

The proposal indicates that the administration will work with Congress to pair the credits with strong labor standards.

Applications for the additional 48C tax credits would be made during the three-year period beginning on the date on which the additional authorization is enacted. The proposal would be effective after December 31, 2021.

KPMG observation

The proposed direct pay option would allow the section 48C credit to more effectively benefit the recipients, many of which would be new ventures with little or no tax liability. And unlike the ITC or PTC, the section 48C credit generally has not been monetized through tax equity investment.

Establish tax credits for heavy- and medium-duty zero emissions vehicles

The administration's FY 2022 proposal includes a new business tax credit for new medium- and heavy-duty zero-emission vehicles, including battery electric vehicles and fuel cell electric vehicles. Eligible vehicles would be those listed under Classes 3 through 8 of the Federal Highway Administration's vehicle classification system. This would be an expansion of the current tax credit under Section 30D that only applies to passenger vehicles and light-duty trucks.

For vehicles acquired for use or lease by the taxpayer, the credit would range from $25,000 - $120,000 during 2022-2024 (depending on the class of the vehicle), with a phasedown to $10,000 - $100,000 during 2027, with a complete phase-out beginning in 2028. Each class of vehicle from Class 3 to Class 8 would have a separate phasedown schedule.

Under the proposal, taxpayers would be able to elect to receive a cash payment in lieu of a tax credit through a direct pay mechanism. The proposal indicates that the administration would work with Congress to pair the credits with strong labor standards.

KPMG observation

The current Section 30D credit has a phasedown on a per-manufacturer basis, with the credit phasing down once a single manufacturer has sold 200,000 vehicles. It is unclear whether there would be a similar phasedown for heavy- and medium-duty vehicles on top of the annual phasedown.

Provide tax incentives for sustainable aviation fuel

For periods beginning after December 31, 2021 and before January 1, 2028, the administration's FY 2022 proposal would introduce:

- A production tax credit of $1.50 per gallon for sustainable aviation fuel that achieves at least a 50% reduction in emissions relative to conventional jet fuel.
- A supplementary credit of up to $0.25 per gallon, available on a sliding scale dependent on the degree of emission reduction.

Currently, there is no income tax credit for sustainable aviation fuel production facilities or property. However, sustainable aviation fuel that is biodiesel (including renewable diesel) is eligible for the $1.00 per gallon biodiesel excise tax credit, which is set to expire on December 31, 2022.

The administration's proposal would require an emissions reduction certification. The supplementary credit would be calculated at a rate of $0.01 for every two percentage points above the 50% reduction baseline. Therefore, sustainable aviation fuel with a 50% emissions reduction relative to conventional jet fuel would receive a $1.50 per gallon credit, while fuel with a 100% emissions reduction would receive a $1.75 per gallon credit. The administration's proposal would pair the credits with certain labor standards.

KPMG observation

Absent limiting language, producers of sustainable aviation fuel may be eligible for the $1.00 per gallon biodiesel credit, the $1.50 sustainable aviation fuel credit, and the supplementary credit for qualifying fuel produced in 2022.

Provide a production tax credit for low-carbon hydrogen

The administration's proposal would provide a new production tax credit when hydrogen is produced under the following two methods:

- Hydrogen is produced using zero-carbon emissions electricity—likely limited to renewables or nuclear energy—and using water as a feedstock or
- Hydrogen is produced using natural gas as a feedstock and with all the carbon emitted in the production process being captured and sequestered.

The credit would be available for each kilogram of qualified low-carbon hydrogen:

- Produced by the taxpayer and
- For an end-use application in the energy, industrial, chemicals, or transportation sector.

The credit would be available during a six-year period beginning with the date the facility is placed in service.

The initial credit rate would be $3.00 per kilogram of hydrogen between 2022 and 2024 and $2.00 per kilogram between 2025 and 2027. The credit would be indexed annually for inflation beginning after the facility was placed in service.

Taxpayers would have the option to elect a direct pay option in lieu of the tax credits.
The hydrogen may be sold to an unrelated third party or, if directly consumed by the taxpayer that owns the facility, the production must be independently verified.

Construction of an eligible facility must begin prior to 2027.

The proposal states that the administration will "work with Congress on measures to pair these credits with strong labor standards, benefiting employers that provide good-paying and good-qualify jobs."

The proposal would be effective after 2021.

Extend and enhance energy efficiency and electrification incentives

Under current law, taxpayers can claim a variety of deductions and tax credits for investments in energy efficiency property and improvements for their homes and business.

Current law incentives include:

- Section 25C – provides a tax credit for certain expenditures to improve the energy efficiency of a taxpayer's principal residence. Two types of property qualify for the credit: (1) Qualified Energy Efficiency Improvements; and (2) Residential Energy Property Expenditures. The section 25C credit is equal to the sum of 10% of the cost of qualified energy efficiency improvements and eligible costs for residential energy property expenditures, subject to a limit of a $500 nonrefundable tax credit for the taxpayer's lifetime. Under current law the section 25C credit will expire December 31, 2021.

- Section 45L – provides a tax credit for the construction of new energy efficient homes that are purchased on or before December 31, 2021. The Section 45L credit is $2,000 per dwelling unit, generally.

- Section 179D – provides a tax deduction for energy efficient commercial building property. The maximum allowable section 179D deduction is $1.80 per square foot. This deduction was made permanent in 2020.

The proposal would provide for the following extensions and expansions with respect to these three incentives, and would add a new credit for mechanical insulation labor costs:

- Section 25C – would extend the credit five years and increase the lifetime limit to $1,200; it would also increase the credit rate to 15% for qualified energy efficiency improvements.

- Section 45L – would increase the credit to $2,500 and extend the credit five years to the end of 2026.

- Section 179D – would increase the maximum section 179D deduction per square foot up to $3.00 per for qualifying property placed in service beginning in 2022.

- Mechanical insulation labor costs – would create a new general business tax credit for qualifying mechanical insulation labor costs. The credit would be 10% of such costs. Such costs would include the labor cost of installing mechanical insulation property, including insulation materials, and facings and accessory products, for a depreciable mechanical system.

The proposal indicates that the administration will work with Congress to pair the credits with strong labor standards.

KPMG observation

These provisions generally would extend and expand three current energy efficiency tax incentives. The inclusion of these extension/expansion provisions was expected.

The mechanical insulation labor cost credit would be new to the tax code.

Provide disaster mitigation credit

The administration's FY 2022 proposal includes a new nonrefundable tax credit for homeowners and businesses equal to 25% of qualified disaster mitigation expenditures, capped at $5,000. The new credit would begin to phase out for individuals with an adjusted gross income ("AGI") of $85,000 ($170,000 for

joint filers) and for businesses when the business has gross receipts above $5 million. The credit would only be available in areas where a federal disaster declaration has been made (or areas adjacent to such areas) within the preceding 10-year period.

The purpose of this credit is to incentivize disaster damage mitigation, as current law does not provide any tax benefits for damage prevention. According to the proposal, mitigation has been shown to provide a great amount of value; for every $1 of mitigation expenditures, it is estimated that $4 of rehabilitation costs post-disaster can be avoided.

KPMG observation

It is not clear how much the credit would incentivize mitigation activities given (i) the relatively low phaseout thresholds for individuals and businesses and (ii) the relatively low maximum value of the credit.

Additionally, the entire United States is currently under a federal disaster due to the COVID pandemic. The provision appears to be drafted for typical natural disaster mitigation; thus, it is unclear whether the entire country would satisfy the "prior 10-year" requirement due to the federal disaster declaration for COVID.

Expand and enhance the carbon oxide sequestration credit

The administration's FY 2022 proposal would extend and modify the section 45Q credit for carbon oxide sequestration.

Current law section 45Q allows credits to taxpayers who capture and sequester qualifying carbon oxide. The amount of the credit depends on how the capture carbon oxide is used. For carbon oxide disposed of in permanent storage and not used in an EOR project, the credit increases to $50 per metric ton by 2026 and is adjusted for inflation in later years. For carbon oxide that is used as a tertiary injectant in an EOR project or utilized in a commercial product or process, the credit increases to $35 per metric ton in 2026 and is adjusted for inflation in later years.

Under section 45Q facilities must meet certain minimum capture thresholds in order to claim the credit. For qualified facilities other than electric generating facilities, taxpayers generally must capture and sequester 100,000 metric tons of carbon oxide per tax year. For electric generating facilities, taxpayers must capture and sequester at least 500,000 metric tons of carbon oxide per tax year. A lower threshold of 25,000 metric tons is available if the carbon oxide is deployed in utilization projects. Qualified facilities must begin construction by January 1, 2026. Taxpayers may claim these credits for a 12-year period from the date the carbon capture equipment was originally placed in service.

The administration's FY 2022 proposal would extend the beginning of construction deadline by five years, such that qualified facilities must begin construction by January 1, 2031.

The proposal would also provide enhanced credit rates for carbon oxide captured in certain industrial processes. Specifically, the proposal would provide an additional $35 per metric ton for carbon oxide which is captured from sectors such as cement production, steelmaking, hydrogen production, and petroleum refining and permanently disposed of in secure geological storage. The additional $35 is not

adjusted each year. For example, the total per ton credit for these types of projects would be $85 in 2026. Also proposed is an enhanced credit for direct air capture projects of an additional $70 per metric ton of qualified carbon oxide for qualified carbon oxide that is disposed of in secure geological storage. The additional $70 per-ton additional credit is not adjusted each year. For example, the total per-ton credit for these direct air capture projects would be $120 in 2026.

Under the proposal, taxpayers would be able to elect to receive a cash payment in lieu of a tax credit through a direct pay mechanism.

The proposal indicates that the administration will work with Congress to pair the credits with strong labor standards.

The proposal would be effective after December 31, 2021.

KPMG observation

The changes to section 45Q included in the administration's FY 2022 proposal would be welcome by the investors in these projects. The election to receive a cash payment in lieu of a tax credit would be particularly meaningful. As previously observed, a direct pay option for energy tax credits would change the landscape and minimize the need to seek outside tax equity investors. For section 45Q, the sheer volume of potential tax credits available for these projects almost necessitates the use of tax equity, however, typical tax equity investors have been hesitant to jump in for a variety of reasons including novel technology, offtake and storage uncertainty, and commodity price risk. A direct pay section 45Q tax credit would make these projects significantly less complicated to finance. Note, however, that the proposal's effective date is not specific about how it would apply or interact with the beginning of construction deadline. For instance, it is not clear whether the direct pay and the enhanced credit amounts would be available to a project which started construction in 2020 but will be placed in service in 2022. Finally, this proposal would not make changes to the minimum capture thresholds under current law section 45Q. The current law minimum capture thresholds have proven difficult to satisfy for some projects.

Extend and enhance the electric vehicle charging station credit

Under current law, taxpayers are eligible to claim an income tax credit for up to 30% of the cost of electric vehicle recharging stations. The credit is capped at $30,000 per location per year for business taxpayers and $1,000 for recharging stations installed at an individual's residence. The credit is not available for recharging stations placed in service after 2021.

The proposal would make five significant changes to the credit. It would:

- Increase the cap on the business credit;
- Remove the "per location" limit for the business credit;
- Extend the credit five years (to 2026);
- Allow business taxpayers to elect a cash payment in lieu of the general business credit; and
- Limit the credit to investments that meet "strong labor standards." (see below)

For business taxpayers, the credit cap would be increased from $30,000 to $200,000. Thus, a single retail

location that had, for instance, installed four recharging stations at one location could potentially claim up to an $800,000 credit. Whereas before, the combination of the credit cap and the "per location" rule would have limited that taxpayer to a $30,000 credit in total for that location.

The proposal states that the administration will "work with Congress on measures to pair these credits with strong labor standards, benefiting employers that provide good-paying and good-qualify jobs."

The proposal would be effective for charging stations placed in service after 2021.

Reinstate superfund excise taxes and modify oil spill liability trust fund financing

For periods beginning after December 31, 2021, and before January 1, 2032, the administration's FY 2022 proposal would reinstate at double the previous rates the following Superfund excise taxes that were imposed prior to 1996:

- An excise tax on domestic crude oil and imported petroleum products at a rate of $0.097 per barrel (oil spill tax).
- An excise tax on listed hazardous chemicals at a rate that varied from $0.22 to $4.87 per ton (chemical excise tax).
- An excise tax on imported substances that use, as materials in their manufacture or production, one or more of the hazardous chemicals subject to the chemical excise tax.

Currently, the oil spill tax is imposed at a rate of $0.09 per gallon on: (1) crude oil received at a U.S. refinery; (2) imported petroleum products entered into the United States for consumption, use, or warehousing; and (3) any domestically produced crude oil that is used (other than on the premises where produced for extracting oil or natural gas) in or exported from the United States if, before such use or exportation, no taxes were imposed on the crude oil. Crudes such as those produced from bituminous deposits and kerogen-rich rock (e.g., tar sands) are not treated as crude oil or petroleum products for purposes of the oil spill tax. The oil spill tax is dedicated to the Oil Spill Liability Trust Fund.

The Customs drawback statute (Title 19 U.S.C. (Customs Duties) section 1313) has been administratively interpreted to allow drawback of the oil spill tax when products subject to this tax are exported.

The administration's proposal would extend application of the oil spill tax to crudes such as those produced from bituminous deposits and kerogen-rich rock. For periods after December 31, 2021, the proposal would also prohibit a drawback of the tax under the Customs drawback statute (19 U.S.C. 1313) when products subject to the tax are exported.

The revenues from the chemical excise tax and tax on imported substances would be dedicated to the Hazardous Substance Superfund Trust Fund.

KPMG observation

In 2020, a U.S. district court held that the oil spill tax violates the Export Clause of the Constitution when imposed on domestically produced crude oil that is exported from the United States if, before such exportation, the oil spill tax had not already been imposed on it. The United States has appealed this opinion to the 5th Circuit. Depending on the outcome of the litigation, the

administration's proposal might have no effect on untaxed exported crude.

Taxation of high-income taxpayers

Increase the top marginal income tax rate for high earners

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

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

Proposal

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

If the proposal were enacted as proposed, beginning in tax year 2022 the 39.6% top marginal individual income tax rate would apply to taxable income over $509,300 for married individuals filing a joint return, $452,700 for unmarried individuals (other than surviving spouses), $481,000 for head of household filers, and $254,650 for married individuals filing a separate return. Under the proposal, the income brackets subject to the top marginal individual income tax rate would be indexed for inflation after the 2022 tax year.

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

KPMG observation

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

KPMG observation

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

income over $400,000.

KPMG observation

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

KPMG observation

The TCJA eliminated the so-called "marriage penalty"—the difference in tax liability of an unmarried couple filing as single taxpayers as opposed to filing jointly as a married couple—in all but the highest tax brackets. The proposal would lower the threshold at which the highest tax bracket applies, so while the marriage penalty would still only apply to married couples in the highest bracket, more couples would be affected.

For example, under current law, a married couple when both spouses have $300,000 of taxable income would have a federal income tax liability of $159,088 if they filed a joint tax return (combined taxable income of $600,000), which is twice the amount of their respective federal income tax liability ($79,544) if they filed as unmarried single individuals. Thus, the couple is not subject to an increase in tax as a result of being married and filing a joint tax return.

Under the proposal, the couple would have the same federal income tax liability ($79,544) as under current law if they would each file as single individuals, however, their federal income tax liability would increase to $163,261 if they would file as married filing jointly. Since their federal income tax liability of $163,261 when filing jointly would be more than their combined federal income tax liability of $159,088 when filing as single individuals, they would incur a marriage penalty of $4,173 (the difference between $163,261, their federal income tax liability when filing jointly, and $159,088, their combined federal income tax liability had they not been married and filed as single individuals).

KPMG observation

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

Taxation of capital income

Tax capital income for high-income earners at ordinary rates

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

Proposal

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

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

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

The proposal would be effective for gains required to be recognized after the date of announcement.

KPMG observation

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

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

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

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

KPMG observation

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

KPMG observation

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

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

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

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

KPMG observation

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

based on the administration's proposal might resemble these congressional proposals

KPMG observation

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

KPMG observation

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

KPMG observation

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

KPMG example

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

Assume instead that in 2022 Taxpayer decided to gift the shares to his heirs prior to death and has

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

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

KPMG observation

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

KPMG observation

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

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

KPMG observation

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

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

KPMG observation

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

KPMG observation

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

KPMG observation

As discussed, it is not clear what specific transfers to or distributions from trusts would be treated as deemed realization events under the proposal; this makes it difficult to assess the potential impact of the proposal on various trusts set up for estate planning purposes, such as a grantor retained annuity trust (GRAT) or a sale to an intentionally defective grantor trust (IDGT). Would the proposal apply to the initial transfer to the trust? For an IDGT, the answer appears to be yes because it is a completed gift for gift tax purposes. But only the remainder interest in a GRAT is a completed gift and that amount is typically worth close to zero when a short-term, high payout GRAT is utilized, so it is unclear whether creation of such a GRAT would be a deemed realization event. Would the proposal apply to a distribution of appreciated assets by a GRAT to the grantor in

satisfaction of the grantor's annuity payment? The grantor is already the owner of the GRAT assets for income and transfer tax purposes, but perhaps this could still be a realization event if distribution means a change in title for property law purposes. It is also not clear whether a sale of appreciated assets from the grantor to an IDGT (which are generally treated as disregarded for federal income tax purposes) in exchange for a promissory note or the trust's use of appreciated assets to satisfy its obligations under the promissory note would be a "transfer of property into" or a "distribution in kind from" the trust and therefore a realization event. Treatment of the exercise of a substitution power is similarly uncertain—is reacquiring appreciated assets from a trust in exchange for other assets of equivalent value one or both of a "distribution from" or a "transfer to"? If the proposal is developed further to treat many of these aspects of GRATs and sales to IDGTs as realization events, the tax benefits associated with these popular estate planning techniques could be significantly reduced. It is worth noting, however, that many of the proposals made by prior administrations that might have had a negative impact on GRATs (e.g., minimum gift amounts or longer required terms) and sales to IDGTs (e.g., inclusion of sold assets in the grantor's estate) are not included in this proposal.

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

KPMG observation

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

KPMG observation

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

KPMG observation

One of the current benefits of a charitable remainder trust (CRT) is the ability to transfer appreciated assets into the trust and have the trust sell the assets and reinvest the proceeds without immediate income tax consequences. Because the trust is a tax-exempt entity, the gain is not subject to tax unless and until a distribution is made, allowing 100% of the value of the assets to appreciate further inside the trust for the benefit of the donor and charity. If the proposal

became law, a contribution of appreciated assets to a CRT which is set up to provide the minimum required actuarial amount of 10% for the charitable remainderman while the donor retains the other 90%, might cause the donor to realize 90% of the total gain making such contributions far less tax efficient. However, it is unclear whether the definition of transfer would include incomplete gifts or not; if not, then creating a CRT in which the donor retains a 90% interest may still provide income tax benefits. Since charitable lead trusts (CLT) are typically zeroed out—i.e., the value of any remainder for the grantor's children is zero based on the required assumptions—the grantor might be able to exclude 100% of the gain on the appreciated assets used to fund the CLT since that would be the portion attributable to the charitable beneficiary.

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

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

KPMG observation

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

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

KPMG observation

Although the 15-year payment plan provision only appears to apply to transfers at death, the family business deferral provision is more broadly stated such that it may be intended to apply to gifts or bequests of family business interests as well. These relief provisions would need to be significantly

expanded upon in order to address all the potential issues they raise. It is possible that the details might resemble parts or all of the current rules regarding the deferral of estate tax attributable to inclusion of closely held business interests in a decedent's estate.

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

KPMG observation

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

Net investment income and self-employment contributions act taxes

The administration's proposal would make a variety of changes to the NIIT and SECA tax for high-income taxpayers (with AGI in excess of $400,000), including subjecting active passthrough business income to either NIIT or SECA tax.

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

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

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

KPMG observation

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

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

The proposal contains an exclusion element associated with taxpayers with AGI falling below $400,000. However, the proposals fall short of the expansive FICA/SECA "donut hole" provision that had been part of Biden's proposals during his presidential campaign. The donut hole proposal would have subjected all wages and certain partnership income to the full amount of FICA (12.4%, with employee share of 6.2%) or SECA (12.4%) for earners making over $400,000.

The expansion of the definition of net investment income to include gross income and gain from any trade or business not otherwise subject to self-employment taxes would impose NIIT on the rental income and gain derived in a trade or business of high-income real estate professionals. Under the proposal, while the income of high-income taxpayers may be subject to a 3.8% tax under either SECA or NIIT, the classification as self-employment income as compared to net investment income may still have an impact on the taxpayer's overall tax liability for the year. For example, tax from SECA may be partially deductible, where tax from NII would not. Or, for example, the taxpayer may have offsetting losses from NII or SECA which may be available to utilize against the changes noted above, potentially favoring one classification over another.

Workers, families, and economic security

Make permanent the American Rescue Plan expansion of premium tax credits

The premium tax credit (PTC) is provided to certain individuals who purchase health insurance through a marketplace exchange established 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 an advance payment of the PTC is based on household income and family size, determined by reference to an individual's most recent available year of tax data. As the advance payment of the PTC is based on prior year tax data, some taxpayers must reconcile their PTC by either paying back the advance payment (because actual income exceeded estimated income) or receiving a refund (because actual income was less than the estimated income).

Prior to the changes introduced by ARPA, the PTC was generally available to individuals with household income between 100 and 400% of the federal poverty line.

For 2021 and 2022, ARPA modified the PTC by reducing the percentage of annual income that households are required to contribute towards the premium and making individuals with income above 400% of the federal poverty line eligible for the credit. ARPA also suspended the requirement that taxpayers repay excess advance PTC payments for tax year 2020.

Proposal

The proposal would permanently expand the PTC by decreasing the applicable contribution percentages of household income used for determining the PTC and permanently extending 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, 2022.

KPMG observation

While ARPA suspended the requirement that taxpayers increase their tax liability by all (or a portion of) their excess advance payments of the PTC for tax year 2020, the proposal does not mention whether this temporary suspension would be further extended.

Make permanent the expansion of the earned income tax credit (EITC) for workers without qualifying children

The EITC supports low to moderate income working families by providing a refundable credit to reduce tax liability. The EITC provides a credit equal to a percentage of worker's earnings up to a maximum credit. Both the maximum credit and the credit rate vary by family size, with the result that larger families receive a larger credit. For 2021, ARPA enacted a number of provisions expanding EITC eligibility for workers without qualifying children (childless workers).

For childless workers, ARPA provided a number of temporary EITC changes effective only for 2021, including:

- Lowering the minimum age from 25 to 19 (18 for certain former foster and homeless youth)
- Eliminating the maximum age at which the credit was available (age 64)
- Increasing the maximum credit available from $543 to $1,502
- Increasing the income threshold for single filers from $15,980 to $21,430 and from $21,920 to $27,370 for married taxpayers filing jointly

Beginning in 2021 and effective for all subsequent years, ARPA provided that taxpayers with children who would otherwise qualify for the EITC but for the fact that the children do not have a social security number may claim EITC as childless workers.

Proposal

The proposal would make permanent the expanded EITC for childless workers enacted in ARPA and would provide that various phase-in and other income ranges would be indexed for inflation.
This proposal would be effective for tax years beginning after December 31, 2021.

Make permanent American Rescue Plan changes to the child and dependent care tax credit

The child and dependent care tax credit (CDCTC) is a credit meant to partially reimburse eligible taxpayers for certain child and dependent care expenses incurred while the taxpayer is working, training, or looking for work.

Tax years before and after the 2021 tax year

Under current law, for tax years before and after the 2021 tax year, the CDCTC is nonrefundable. An eligible taxpayer is allowed a maximum credit of up to 35% of up to $3,000 in eligible expenses for one qualifying individual (or $6,000 in eligible expenses for two or more qualifying individuals). A qualifying individual includes a qualifying dependent child under the age of 13, or a spouse or other dependent who is physically or mentally incapable of caring for himself or herself and who has the same principal abode as the taxpayer for more than one-half of the tax year.

A taxpayer is eligible to exclude up to $5,000 in employer-provided dependent care assistance. In computing the CDCTC, the eligible expense limitation is reduced by any employer-provided dependent care benefits that are excluded or deducted from an eligible taxpayer's income.

An eligible taxpayer's maximum reimbursement percentage is reduced by one percentage point for each $2,000 (or fraction thereof) by which the taxpayer's AGI exceeds $15,000, until the taxpayer's maximum reimbursement percentage reaches 20% at AGI of $43,000. This 20% rate continues to apply at all income levels above $43,000.

Tax year 2021

ARPA made special, temporary modifications to the CDCTC for the 2021 tax year. For tax year 2021, the CDCTC is fully refundable for eligible taxpayers with a principal abode in the United States for more than one-half of the 2021 tax year. Additionally, the maximum reimbursement percentage is increased from 35% to 50% for 2021, and the eligible expense limitation is increased from $3,000 to $8,000 for one qualifying individual (and from $6,000 to $16,000 for two or more qualifying individuals).

ARPA applies a two-part phase-out to the reimbursement percentage phase out for tax year 2021. An eligible taxpayer's maximum reimbursement percentage is reduced by one percentage point for each $2,000 (or fraction thereof) by which the taxpayer's AGI exceeds $125,000, until the taxpayer's maximum reimbursement percentage reaches 20% at AGI of $183,000. This 20% rate applies at all income levels below $400,000. An eligible taxpayer's maximum reimbursement percentage begins decreasing again by one percentage point for each $2,000 (or fraction thereof) by which AGI exceeds $400,000 and is reduced to zero at AGI in excess of $438,000.

ARPA increased the exclusion for employer-provided dependent care assistance to $10,500. It also

provides for a reimbursement for the cost or value of the refundable CDCTC for U.S. territories.

Proposal

The proposal would make permanent the temporary modifications to the CDCTC for the 2021 tax year that were enacted in ARPA. The proposal would also establish a number of reporting requirements with respect to the CDCTC, including adding the CDCTC to the list of credits subject to paid preparer due diligence requirements, requiring taxpayers to provide certain information about the organizations or persons providing the care, and establishing an information return requirement for agencies that provide childcare subsidies.

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

KPMG observation

By making ARPA's modifications to the CDCTC permanent, the proposal would greatly increase the benefit to most taxpayers, but completely deny the credit to higher-income taxpayers who are presently eligible for a reduced benefit for tax years after 2021.

Extend the child tax credit increase through 2025 and make permanent full refundability

Taxpayers may claim a child tax credit (CTC) for each qualifying dependent child with the appropriate taxpayer identification number (TIN). The value of the CTC, the amount of any refundable portion of the CTC, the age of a qualifying dependent child, and TIN requirements, vary based on the tax year due to the temporary provisions within the 2017 tax law known as the TCJA and the temporary provisions within ARPA.

For the 2021 tax year, the CTC a taxpayer may claim is made of up of two components; the CTC that was enacted by the TCJA, effective for tax years 2018 through 2025 and the increased CTC provided for in ARPA, effective for the 2021 tax year only.

CTC allowed under the TCJA: Effective for tax years 2018 through 2025, excluding tax year 2021

Taxpayers may claim a CTC of up to $2,000 per qualifying dependent child under the age of 17 with a Social Security Number (SSN). The credit is generally refundable up to $1,400 per qualifying dependent child if the taxpayer has earned income of up to $2,500 and does not claim the foreign earned income exclusion. The TCJA also created a new, nonrefundable $500 credit for nonqualifying child dependents (ODTC). Under the TCJA, the CTC and ODTC together are phased out by $50 for each $1,000 by which a taxpayer's modified adjusted gross income (MAGI) exceeds $200,000 ($400,000 for married couples filing jointly).

CTC allowed under ARPA: Effective for tax year 2021

For tax year 2021 only, ARPA:

- Increased the CTC amount to $3,000 per qualifying dependent child age six and older and $3,600 per qualifying dependent child under the age of six,
- Increased the age limit of a qualifying child to include a dependent child under the age of 18,
- Made the CTC fully refundable for taxpayers with a principal place of abode in the United States for more than one-half the tax year, and
- Removed the earned income requirement.

ARPA did not modify the ODTC.

ARPA created a new phase-out range for the additional $1,000 per qualifying child (or $1,600 per qualifying child under age six) credit amount provided under ARPA. The additional credit amount is phased out by $50 for each $1,000 by which a taxpayer's MAGI exceeds $75,000 ($112,500 for head of household; $150,000 for married couples filing jointly). The remaining $2,000 CTC amount allowed under the TCJA is phased out by $50 for each $1,000 by which a taxpayer's MAGI exceeds $200,000 ($400,000 for married couples filing jointly).

ARPA directed the Treasury to establish a temporary program for making advanced periodic payments to taxpayers during 2021. These payments may equal up to 50% of what the Treasury estimates to be the refundable CTC amount based on the taxpayer's 2020 return (or 2019 return if the 2020 return is not available) considering the passage of time with respect to the ages and status of the taxpayer's qualifying children.

Additionally, ARPA directed the Treasury to create an online information portal where taxpayers may elect to not receive the advanced periodic payments, or may make the Treasury aware of any changes during the year that might impact the advanced amount (e.g., birth of a qualifying child, change in marital status, or change in income). If a taxpayer receives advance payments in excess of the CTC for 2021, the taxpayer's federal tax liability may be increased by the excess amount received, subject to a safe harbor based on a taxpayer's MAGI.

ARPA provided for a reimbursement for the cost of the credit for certain U.S. territories.

For tax years after 2025

For tax years after 2025, a taxpayer may claim a CTC of up to $1,000 per qualifying dependent child with a SSN or an individual taxpayer identification number (ITIN). The refundable portion of the CTC will be the lesser of $1,000 per qualifying child, or 15% of earnings in excess of $3,000. The CTC will be phased out for taxpayers with MAGI over $75,000 ($110,000 for married couples filing jointly).

Proposal

The proposal would generally extend ARPA's temporary 2021 expansion and advance payment of the CTC through tax year 2025. Additionally, the proposal would make the CTC permanently fully refundable, regardless of a taxpayer's earned income, for all tax years going forward.

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

KPMG observation

Under current law, while many higher-income taxpayers (i.e. single taxpayers with MAGI over $200,000 and couples with MAGI over $400,000) will not receive the benefit of ARPA's 2021 expanded CTC amount, they could still receive the smaller CTC amount in 2021 under the TCJA ($2,000 per qualifying child).

Likewise, under the proposal, these higher-income taxpayers would not qualify for the increased CTC in 2022-2025 due to their income level. However, these taxpayers would potentially still qualify for the CTC amount allowed under the TCJA ($2,000 per qualifying child) through tax year 2025, due to the phase out at a higher income threshold.

KPMG observation

Under current law applicable in 2021, if the amount of advance CTC payments received by a taxpayer during the tax year exceeds the CTC amount the taxpayer would be allowed on the taxpayer's tax return for that year, the taxpayer's federal income tax liability would be increased, dollar-for-dollar, by the excess advance CTC payment amount. Taxpayers who elect to opt out of advance CTC payments would receive the refundable amount of the CTC as a lump sum when they file their tax return, avoiding the need to complete a year-end reconciliation and to make a potential repayment of the excess advance CTC payment received. If the administration's proposal is enacted, this could also be the case with regard to advance CTC payments applicable to 2022-2025.

Increase the employer-provided childcare tax credit for businesses

The administration's proposal would expand the business credit under section 45F for an employer-provided childcare facility.

Currently, section 45F allows an employer a credit of 25% of qualified care expenses and 10% of referral expenses, for a maximum annual credit of $150,000. Qualified expenses include acquisition, construction, rehabilitation or expansion of properties, operating costs, or contracting with a qualified childcare facility to provide services for the taxpayer's employees.

The administration's proposal would increase the allowed tax credit to 50% of the first $1 million of qualified care expenses, for a maximum business credit of $500,000. The proposal would leave the 10% credit for referral expenses unchanged with a limit of $150,000. The proposal would be effective for tax years beginning after December 31, 2021.

KPMG observation

The potential for increased credits is welcome news for employers. However, it remains to be seen what the future forward workplace paradigm will look like and the role the increased credit could play in that dynamic. Employers looking to add childcare options and to provide a more

competitive workplace will want to monitor this potential credit expansion.

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, 2021.

Repeal deferral of gain from like-kind exchanges

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

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

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

KPMG observation

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

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

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

Regarding the impact on a taxpayer's income tax bases in various states, because states generally adopt federal income as the starting point for computation of the state income tax base, if a state automatically conforms to the Code and this federal change is made, the state would correspondingly require gain to be recognized from exchanges with amounts exceeding the federal thresholds. Similarly, if the proposed federal rule is enacted, and a state with static conformity updates its rules to follow the federal rule change, then a taxpayer in this state would also recognize gain from exchanges with amounts exceeding the federal thresholds. If a state with

static conformity does not update its conformity to the Code, then gain from an exchange may continue to be deferred for the income tax base in that state. The determination of the overall impact on the exchanging parties may vary by state if the properties involved in the exchange are located in multiple states because certain of these states may follow the federal recognition rules while other states may continue to permit the deferral.

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

Make permanent excess business loss limitation of noncorporate taxpayers

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

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

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

KPMG observation

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

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

Improve compliance

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

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

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

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

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

KPMG observation

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

Introduce comprehensive financial account reporting to improve compliance

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

The proposal would create a comprehensive financial account information reporting regime under which financial institutions would be required to report data on certain financial accounts on an annual Form

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

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

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

KPMG observation

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

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

Improve tax administration

Increase oversight of paid tax return preparers

Oversight of paid preparers by the Internal Revenue Service

Under current law, the Treasury Secretary has the authority to regulate practice before the IRS by licensed attorneys, certified public accountants, and enrolled agents and actuaries. See Title 31 U.S.C. Section 330 – Practice before the Department, known as "Circular 230." Circular 230 was amended in

2011 to regulate the practice of all paid tax return preparers, including individuals who are unlicensed and unenrolled, including to require that paid tax-return preparers pass an initial certification exam, pay annual fees, and annually complete at least 15 hours of continuing education. In *Loving v. Commissioner*, 742 F.3d 1013 (D.C. Cir. 2014), the court held that the IRS's authority under Title 31 U.S.C. Section 330 could not be stretched so broadly as to encompass authority to regulate tax return preparers. The administration asserts that regulation of paid tax return preparers, in conjunction with diligent enforcement, will help promote high-quality services from paid tax return preparers and improve voluntary compliance.

The administration's FY 2022 proposal would amend Title 31 of the U.S. Code to provide the Secretary with explicit authority to regulate all paid preparers of federal tax returns, including by establishing mandatory minimum competency standards.

The proposal would be effective on the date of enactment.

KPMG observation

Although it appears the administration's intent is to impose the mandatory minimum competency standards on unlicensed and unenrolled paid return preparers, that objective is not made clear based upon the language of the proposal. As a result, there is uncertainty whether the proposal would impose mandatory minimum competency standards on not only unlicensed and unenrolled paid return preparers, but also on other paid return preparers.

Increase penalties on ghost preparers

Under current law, anyone who is paid to prepare or assists in preparing federal tax returns must sign and include their Preparer Tax Identification Number (PTIN) on the returns. The penalty for failure to identify a paid tax return preparer is $50 per return, not to exceed $25,000 per preparer per year.

The administration's FY 2022 proposal would increase the penalty amount to the greater of $500 per return or 100% of the income derived per return by so called "ghost preparers," *i.e.*, paid preparers of federal tax returns who fail to identify themselves on the returns, including indicating a valid PTIN. The proposal would also increase the period of limitations for assessment of the penalty from three years to six years.

The proposal would be effective for returns required to be filed after December 31, 2021.

Enhance accuracy of tax information

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

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

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

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

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

1) Income tax returns of individuals with gross income of $400,000 or more;
2) Income, estate, or gift tax returns of all related individuals, estates, and trusts with assets or gross income of $400,000 or more in any of the three preceding years;
3) Partnership returns for partnerships with assets or any item of income of more than $10 million in any of the three preceding years;
4) Partnership returns for partnerships with more than 10 partners;
5) Returns of REITs, REMICs, RICs, and all insurance companies; and
6) Corporate returns for corporations with $10 million or more in assets or more than 10 shareholders.

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

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

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

Moreover, the proposal would provide the Secretary with authority to require additional returns, statements, and other documents to be e-filed.
The proposal does not include an effective date.

Improve information reporting for reportable payments subject to backup withholding

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

to a nonemployee for services), 6050A (payments to fishing boat crews), 6050N (royalty payments), and 6050W (payments made in settlement of payment card and third party network transactions).

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

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

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

KPMG observation

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

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

Expand broker information reporting with respect to crypto assets

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

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

taxpayers reciprocally.

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

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

KPMG observation

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

Address taxpayer noncompliance with listed transactions

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

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

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

to collect taxes that are legally owed.

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

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

KPMG observation

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

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

While the secondary liability proposal would change the existing rules, the circumstances in which it would apply are similar to those described in Notice 2008-111, though the proposal would cast a

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

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

Modify tax administration rules

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

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

KPMG observation

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

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

KPMG observation

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

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

KPMG observation

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

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

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

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

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

Modify requisite supervisory approval of penalty included in notice

Section 6751(b)(1) provides that no penalty under the Code shall be assessed unless the initial determination of such assessment is personally approved in writing by the immediate supervisor of the individual making such determination or such higher-level official as the Secretary may designate. Section 6751(b) applies to all penalties imposed by the Code, except it does not apply to failure-to-file and failure-to-pay penalties under section 6651, estimated tax payment penalties under sections 6654 and 6655, or any other penalties that are automatically calculated through electronic means. Under Section 7491(c), the IRS has the burden of production with respect to the liability of any individual for any penalty under the Code, meaning the IRS has the burden to present sufficient evidence showing that it is appropriate to impose the relevant penalty.

Several recent court decisions have considered taxpayer arguments that the IRS failed to obtain supervisory approval prior to assessing a penalty. These decisions have addressed, among other issues, the timing of the requisite approval, who must sign the approval, and which penalties require approval. The Green Book asserts that these court decisions have led to uncertainty regarding the application of section 6751(b) and have required approval prior to the time a supervisor may have all the information relevant to a decision whether a penalty is appropriate.

The Green Book observes that in cases where the IRS approval did not occur before the court-imposed deadline, "courts have barred penalties without considering whether the penalties were appropriate under the facts of the particular case." According to the Green Book, these barred penalties have included accuracy-related penalties where the taxpayers did not otherwise demonstrate reasonable cause, penalties attributable to reportable transactions that the IRS identified as tax avoidance transactions or that taxpayers entered into with a significant purpose of income tax avoidance or evasion, and even civil fraud penalties where the IRS met its burden of showing clear and convincing evidence of fraud. The Green Book concludes that these court decisions "undercut the purpose of penalties to deter taxpayer non-compliance with tax laws, based on unclear, hard to apply rules that often apply retroactively."

The proposal would make several changes to the existing law, including:

- Clarifying that a penalty can be approved at any time prior to the issuance of a notice from which the Tax Court can review the proposed penalty (for example, a notice of deficiency);
- Permitting the IRS to raise a penalty in Tax Court if there is supervisory approval before doing so;
- Providing that supervisory approval may occur at any time before assessment of any penalty not subject to Tax Court review prior to assessment;

- Expanding approval authority from an "immediate supervisor" to any supervisory official, including those that are at higher levels in the management structure or others responsible for review of a potential penalty; and
- Eliminating the written approval requirement for accuracy-related penalties imposed by sections 6662 and section 6662A and for fraud penalties imposed by section 6663.

This proposal would be effective upon enactment.

KPMG observation

As described in the recent case law, the original purpose behind section 6751(b) was to ensure that penalties were appropriately asserted and not used as a "bargaining chip" to pressure taxpayers to settle cases. The proposal appears to undercut that original purpose by delaying the requisite approval until the point at which the Tax Court can review the IRS's adjustments. As a result, the proposal seemingly would allow a revenue agent to seek managerial approval only after the agent has had a chance to assert a penalty in an attempt to pressure a taxpayer to settle on the merits.

Authorize limited sharing of business tax return information to measure the economy more accurately

Current law authorizes the IRS to disclose certain federal tax information ("FTI") for governmental statistical use. Business FTI for all businesses may be disclosed to officers and employees of the Census Bureau. Only corporate business FTI may be disclosed to officers and employees of the Bureau of Economic Analysis ("BEA"). The Bureau of Labor Statistics ("BLS") however, is currently not authorized to receive FTI. FTI includes: Taxpayer identification number; name(s) of the business; business address; principal industry activity; sales revenue (for employer businesses only); number of employees and total business-level wages (including wages, tips, and other compensation).

According to the administration, BEA's limited access to business FTI and BLS's lack of access to business FTI prevent BEA, BLS, and the Census Bureau from synchronizing their business lists, and as a result, preclude improving the consistency and quality of sensitive economic statistics, including productivity, payroll, and employment.

The administration also notes that given the growth of non-corporate businesses, especially in the service sector, the current limitation on BEA's access to corporate FTI impedes the measurement of income and international transactions in the National Accounts, which is important to the formulation of fiscal policies. National Accounts broadly present output, expenditure, and income activities of the economic actors (households, corporations, government) in an economy. National Accounts also include measures of the changes in assets, liabilities, and net worth per accounting period. There are a number of aggregate measures in the national accounts, notably including gross domestic product.

In addition, the Census Bureau's Business Register is constructed using both FTI and non-tax business data derived from the Economic Census and current economic surveys. Because the non-tax business information is inextricably comingled with FTI, the administration points out that it is not possible for the Census Bureau to share data with BEA and BLS in any meaningful way under current law.

The administration's FY 2021 proposal would authorize BEA officers and employees access to FTI of sole

proprietorships with receipts greater than $250,000 and of all partnerships.

The proposal would also authorize BLS officers and employees access to FTI of certain businesses and tax-exempt entities. The proposal would not provide BLS with access to individual employee FTI. In essence, the proposal would allow officers and employees of each of BLS, BEA, and the Census Bureau to access the same FTI for businesses, and would permit BLS, BEA, and the Census Bureau to share such FTI amongst themselves, subject to the certain restrictions.

For the purpose of synchronizing BLS and Census Bureau business lists, the proposal would permit employees of State agencies to receive from BLS the limited enumerated FTI identity items.

The proposal would require information safeguards. Specifically, the proposal would require any FTI to which BEA and BLS would have access, either directly from the IRS, from the Census Bureau, or from each other, to be used for statistical purposes consistently with the Confidential Information Protection and Statistical Efficiency Act. The Census Bureau, BLS, and BEA, along with State agencies would be subject to taxpayer privacy law, safeguards, and penalties.

The proposal would be effective upon enactment.

State and local tax implications

Introduction

As taxpayers prepare to assess the potential impact of the administration's tax proposals on their state tax position and how states would respond to the proposals if enacted, a great deal can be learned from the very recent experience of states responding to enactment of the TCJA in December 2017. This section of the KPMG Report discusses the implications of the administration's proposals for state taxes, with a focus on the impacts for state corporation income taxes. It begins with an overview of certain lessons learned or patterns that emerged in the state responses to TCJA, followed by an overview of the general manner in which states conform to the Code, and then examines the potential implications of particular proposed changes, with a focus on the administration's proposed international changes.

Lessons from the TCJA

The TCJA was the most sweeping set of federal tax changes enacted in 30 years, encompassing dramatic rate reductions, changes in the taxation of domestic enterprises and a restructuring of the international tax regime. The administration's proposals in some areas are on a par with the TCJA in terms of significance and impact. The varying responses of the states to the TCJA can be instructive in assessing possible responses to potential enactment of the administration's proposals.

- It may well take a few years for states to formulate policies around, and enact laws conforming to, or decoupling from, the administration's proposed tax changes. Even now, some 3 ½ years after enactment of the TCJA, states are still considering legislation on whether to include GILTI and section 965 repatriated amounts in the income base, among other matters.

- Even when a state adopts a federal change, guidance on the application of that change for state purposes given differences, for example, in state and federal filing and reporting methods, will not be

forthcoming from all states or may not be forthcoming in a particularly quick fashion. A number of state tax authorities have not issued guidance, for example, on the computation of the section 163(j) interest expense limitation or the manner for including GILTI in the apportionment formula.

- Should the administration's proposals be enacted, taxpayers would need to prepare for a period of non-conformity in the states that do not automatically adopt all federal tax changes. Roughly half of the states require state legislative action to conform to federal law changes, and most state legislative sessions have adjourned by July 1 each year. Depending on when a new federal law is enacted and the effective dates of the provision, state legislatures may not be in a position to adopt legislation to react to the changes in the near term.

- The experience with the TCJA has taught us there would be no uniformity in conformity, and enactment of these proposals would likely lead to vast differences among the states as to what federal policies they adopt or decline to adopt. For example, well over half the states conform to some degree to section 163(j), while fewer than 10 states include the amount of GILTI reflected on the federal return in state taxable income.

- Finally, the extent to which a particular state will conform to any federal changes can be expected to be heavily influenced by a number of state-specific factors, including (1) how the state generally conforms to the Code, (2) the political make-up of the state legislature and executive branch, (3) the state's current and projected fiscal condition, and (4) the state's current treatment, if any, of the Code section under which the change is implemented.

All of this is to say, that taxpayers should fully expect a significant period of fluctuation and uncertainty in the state tax landscape if Congress enacts substantial pieces of the administration's tax agenda. The complexity involved in properly complying with one's state tax obligations would be magnified. Accurately assessing one's state posture in this environment would require vigilant monitoring of state legislative actions and administrative guidance, careful analysis and modeling of the enacted changes, ensuring the required data is available for compliance, and devoting sufficient time and resources to compliance and return filing responsibilities.

Current landscape of state conformity to the Code

Nearly every state corporate and personal income tax conforms in some manner to the Code. Conformity between state and federal taxes simplifies compliance for taxpayers, and at the same time, reduces the administrative burdens facing state tax authorities. States generally conform to the Code in one of two ways. Rolling or current conformity states tie the state tax to the Code for the tax year in question, meaning they adopt all changes to the Code as passed by Congress unless the state passes legislation to decouple from specific provisions. Static or fixed-date conformity states tie to the Code as of a specific date (e.g., December 31, 2021), meaning the state legislature must act to incorporate any subsequent federal changes into the state tax code. States are about evenly divided between rolling and static conformity. A small number of states, notably California, adopt selected Code provisions, rather than using the blanket approach used by most states. Static conformity states generally update their conformity annually or at least regularly. The notable exception is California that currently ties to the Code as of January 1, 2015 and Texas, which currently conforms to the Code as of January 1, 2007.

For corporate income taxes, states generally begin the computation of state corporate taxable income with federal taxable income and therefore allow, for state tax purposes, many federal deductions. A majority of the states start with line 28 of federal Form 1120 (taxable income before net operating losses

and special deductions), and the remainder start with line 30, which includes net operating losses and special deductions. With the enactment of the TCJA, the deductions reported on Line 29b, which include the dividends received deduction and the deductions under section 250 that effectively reduce the tax rate on GILTI and provide the beneficial rate for FDII, became increasingly important to state taxpayers and will likely continue to be consequential given the administration's proposals around FDII and GILTI.

Given the nature of state conformity to the Code, certain types of federal changes would have no effect on state tax liability. States set their own tax rates and have their own credit regimes, as a general matter. Consequently, any federal changes affecting tax rates or business credits (with the R&D credit being an important exception) would essentially have no bearing on state tax liability. Even the administration's proposed minimum tax on global book income would likely have no immediate state impact without a separate state enactment of a similar minimum tax regime. One might be tempted to ask whether the proposed increase in the federal rate from 21% to 28% would result in some states reducing their corporate income tax rates. The answer to that question is likely that there would be little direct effect or impetus. State choices are more heavily influenced by fiscal conditions, comparisons with surrounding states, and political preferences of policy makers than by the federal tax rate.

SALT considerations of select administration proposals

From the perspective of implications for state taxation, the most important of the administration's proposals are those that would make significant changes to the international provisions included in the TCJA and provide a new, additional limitation on the deductibility of interest expense. (See more detail on the **international proposals**.) The proposed changes to GILTI include reducing the section 250 deduction to 25%, eliminating the 10% reduction for deemed returns to QBAI, and computing GILTI on a jurisdiction-by-jurisdiction basis. There are also proposals to eliminate FDII and replace the BEAT regime with a new regime termed SHIELD. Finally, but perhaps a proposal that could be the most impactful for many companies, the administration has proposed additional limitations on the deductibility of interest expense to avoid multinational groups reducing their U.S. tax by over-leveraging their U.S. operations relative to those located in lower-tax jurisdictions.

GILTI: Currently, under section 951A, U.S. Shareholders of CFCs must include in federal taxable income an amount computed by reference the activities of their CFCs. This income inclusion, referred to as GILTI, is computed by taking the taxable income of the CFC determined using rules similar to those applicable to domestic corporate taxpayers less an amount based on 10% of the CFC's adjusted basis in its tangible assets – termed QBAI. The income included under this provision by the domestic parent is eligible for a potential deduction under section 250 equal to 50% (37.5% for years beginning after December 31, 2025) of the foreign subsidiary's GILTI (subject to limitation when GILTI exceeds taxable income). For each CFC, GILTI is aggregated across all countries in which the CFC operates (thus allowing losses to offset positive income). The section 250 deduction limits the effective U.S. income tax rate on GILTI to 10.5% (13.125% in tax year 2026 and beyond). Certain foreign tax credits are allowed at the federal level, but they do not come into play at the state level.

There are about 20 states that currently either through legislative enactment or rolling conformity include some portion of GILTI in their state taxable income base. Fewer than half of these follow the federal approach of including the full amount of GILTI in gross income and allowing the 50% deduction under section 250. The remainder have taken different approaches to GILTI. Several treat GILTI as a foreign dividend and extend the state's dividends-received deduction to GILTI. Others exclude GILTI from income, but disallow expenses related to the generation of GILTI as a deduction or include a relatively small portion of GILTI (e.g., 5%) in income as a proxy for expenses related to otherwise

excluded income. In a few states, section 951A is simply not adopted or operational.

The administration's proposed changes to the GILTI regime include a reduction of the section 250 deduction from 50% to 25% of GILTI (raising the effective U.S. income tax rate to 21% given the proposed 28% rate). This could have a material impact in certain states, particularly those that follow the federal approach to GILTI inclusion. In rolling conformity states that automatically conform to federal changes to the Code and that allow for a section 250 deduction related to GILTI, the reduction in the allowable section 250 deduction would increase the state taxable income base, barring any state law change. In static conformity states, however, those states that allow a section 250 deduction would continue to use the 50% figure until the state updated its conformity or otherwise adopted the federal change. This variance among the states could create compliance difficulties for taxpayers with significant operations in a mixture of rolling and static conformity states.

The administration also proposes to eliminate the deduction of QBAI (10% of a CFC's tangible assets) in computing GILTI and to require the computation of GILTI on a jurisdiction-by-jurisdiction basis, as opposed to aggregating the income/losses of CFCs for a U.S. shareholder across all jurisdictions in which the CFCs operate. Both changes would likely increase the amount of GILTI for federal purposes. The changes would affect the state income tax base differently depending on the type of conformity each state has to the Code. States with rolling conformity that include some portion of GILTI in income would automatically conform to the federal computational changes, while states with fixed or selective conformity would not automatically conform. For fixed conformity states, GILTI would be computed under the existing rules of the TCJA, which allow for QBAI and do not require a jurisdiction-by-jurisdiction calculation method, until further state legislation is enacted. This potential lack of conformity to the federal GILTI changes would create at least two different GILTI computations for state tax purposes (one under the provisions of the TCJA and another using the amended GILTI provisions). While these changes would, in some cases, add to the compliance burden for taxpayers, they could also present opportunities where the TCJA rules that may remain in place in static conformity states (perhaps temporarily) allow for more favorable state treatment of GILTI.
FDII: The TCJA included a new deduction for certain types of foreign-source income under section 250 (the same section of the Code containing the deduction for GILTI). This provision allows a U.S. corporation a deduction equal to 37.5% of its FDII. Starting in 2026, the deduction percentage is reduced to 21.875%. The deduction for FDII is limited when it, combined with the deduction for GILTI, exceeds the corporation's taxable income.

While GILTI was designed to provide a disincentive to locating intellectual property and activities offshore and earning profits overseas, the FDII deduction was intended to be an incentive to locate intellectual property domestically and generate U.S. income from foreign sales. In simple terms, the FDII deduction is computed by considering income from foreign sales (broadly defined) in excess of an assumed 10% return on tangible assets and allowing a deduction for the specified portion thereof. In terms of state conformity to FDII, there are more than 20 states that allow the FDII deduction in some form, including most that follow the federal model of taxing GILTI with a section 250 deduction. Some states that tax a smaller portion of GILTI do not conform to FDII, and there are several states that adopt the FDII deduction, but that decoupled from GILTI. States allowing a FDII deduction include both rolling and static conformity states.

The administration's proposal would repeal FDII and replace it with other as of yet unspecified incentives related to R&D and other activities occurring in the U.S. For state tax purposes, rolling conformity states would automatically conform to the repeal of the FDII deduction. Fixed conformity states that conform to the TCJA version of the FDII deduction, on the other hand, would still allow the deduction subject to any amendments to their conformity dates made by their state legislatures. This

could create a situation where the FDII deduction exists only for state purposes. For taxpayers with a large presence in states that continue to conform to the FDII deduction, the benefit of the deduction could outweigh the compliance costs of computing the state-only deduction. There is a question of the degree to which states can sustain and enforce compliance with a deduction to which there is no federal counterpart as a means of verifying accurate computations.

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

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

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

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

subject to both section 163(j) and the new limitation would apply whichever of the two provisions imposed the lower limitation.

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

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

Global minimum tax. The administration is proposing a 15% minimum tax on worldwide book income for corporation with greater than $2 billion in global book income. An affected taxpayer would pay the greater of the tax owed under the regular income tax or the minimum tax. As this is framed as a freestanding alternative minimum tax computation (rather than being related to federal taxable income), it would require a separate state law to incorporate some form of the minimum tax into the state tax code.

Individual tax provisions. The administration proposes a number of significant changes for individual income taxpayers. For the most part, however, these changes are not expected to have a substantial impact on state individual income taxes due to the manner that states conform to federal law. As with corporation taxes, nearly all states conform on either a rolling or fixed basis to the federal Code. Of the states with a broad-based personal income tax, five use federal taxable income as their starting point, and the large majority (32) begin the state tax calculation with federal adjusted gross income. This means that state income tax rates and individual credits against tax are not tied to federal law and are instead adopted independently by each state. Given that, most of the administration proposals aimed specifically at individual taxpayers would not have a direct impact on state taxes.

More specifically, enactment of the marquee personal income tax proposals from the administration of increasing the top marginal rate and treating capital gains income as ordinary income would have little or no impact at the state level. While some states do provide a differential rate for capital gains, those rates are established by each state and are not tied to the federal rate. The same is true of the carried interest proposal calling for the reclassification of certain income arising from investment services.

The administration is also proposing several changes to expand certain tax credits to aid low- and moderate-income households. Here again, the direct impact on state income taxes is modest, but two proposed changes will be of interest in some states. These are the proposals to make permanent both the expansion of the earned income credit as applied to qualified workers with no children and the amount of credit available under the child and dependent care credit – both of which were part of the recently enacted American Rescue Plan). About 25-30 states have either or both an earned income credit and a child and dependent care credit that is generally modeled in some fashion after the counterpart federal credit. State earned income credits are often expressed as a percentage of the federally allowed credit, and state child and dependent care credits often start with the expenses allowable for federal purposes. To the extent a state ties to either of these federal credits, the administration's proposal would have a corollary impact at the state level, if enacted.

Tax administration proposals. The administration proposes several changes designed to improve tax compliance, primarily by expanding the scope of information report required of certain third parties. Specifically, these proposals include expanding the scope of information reporting to create a comprehensive financial account reporting regime that is intended to improve the ability of the IRS to track inflows and outflows among various accounts with the same owner. The proposed new information reporting requirement would apply to financial institutions and accounts similar to financial institution accounts. It would also apply to various transaction involving crypto assets.

While there is not a direct one-to-one impact on state income tax compliance from the proposed expanded information reporting, states are able to obtain various Form 1099 information reports from the IRS under the section 6103 information disclosure program. It is likely states would seek to formulate improved compliance programs using the expanded information reports as they have with the recent 1099-K reports on credit card transactions.

The administration also proposes a change to the centralized partnership audit regime that would call for net negative adjustments in the report year to be considered an overpayment subject to refund to the taxpayer instead of an amount not available for refund. This proposal is not likely to have a significant impact on the treatment of partnerships and partners at the state income tax level. Since the passage of the centralized partnership audit regime, over fifteen states have enacted legislation related to partnership income adjustments. Most if not all, however, have not followed various aspects of the federal rules. For example, in most states, both the partnership and its partners must still report changes by adjusting income in the reviewed year, as opposed to the report year. Given that state adjustments are generally made for the reviewed year, not the report year, the proposed change would generally not have a state tax impact.

Closing thoughts

With the focus on tax rates and various tax credits to promote energy efficiency and alternative fuels and to support low- and moderate-income households, the administration's FY 2022 tax proposals, if enacted, would not have the dramatic effects that TCJA did on income taxation at the state level for many taxpayers. Nonetheless, corporate income taxpayers, especially multinationals, would likely experience increased complexity in complying with state corporate income tax increases from some of

the proposed changes. The proposed changes in GILTI and the new limitations on the deductibility of interest, along with adoption of SHIELD, would pose substantial compliance challenges as states adjust to the new proposals, adopt various approaches to conforming to the changes, and attempt to coordinate them with their existing regimes. Not conforming to adopted federal changes would also present challenges, particularly if information needed for compliance with the prior federal law is not available to the taxpayer or on revised federal return updated to include the administration's proposals. Accurate compliance with any federal changes would require close monitoring of state legislative and administrative activity, careful analysis of state and federal requirements and dedicating the resources necessary to ensure information necessary for compliance is available.

Impact on accounting for income taxes

The administration's proposals described in the Green Book may significantly impact an entity's accounting for income taxes process and the measurement of income taxes related balances. The tax effects of certain changes in tax laws and rates are reflected in the financial statements beginning with the date of enactment.

As entities assess the impact of the proposals, there may be elements where it is not entirely clear how the taxing authority or a court would interpret the proposals if enacted. Accordingly, entities should also consider the impact the proposals would have on accounting for uncertainty in income taxes. If tax positions arise that are expected to be reported on a tax return that are not highly certain to be sustained upon examination based on the technical merits, an entity should assess the tax position in accordance with the recognition and measurement criteria within ASC 740 to determine the appropriate amount of unrecognized tax benefits to be reflected within the financial statements.

This discussion highlights selected areas of accounting for income taxes that entities may see impacted by changes in tax laws or rates included in the administration's proposals but is not all inclusive.

Corporate tax rate increase

The proposal includes an increase of the corporate tax rate to 28%. In accordance with section 15, fiscal year-end entities would utilize a blended rate for the tax year that straddles the effective date by applying a prorated percentage of the number of days prior to and after the effective date.

Subsequent to the adoption of ASU 2019-12, *Simplifying the Accounting for Income Taxes*, the tax effect of changes in tax laws or rates on income taxes receivable (payable) for the current year is recognized in the estimated annual effective tax rate in the period that includes the enactment date, even if the change is effective in a later reporting period. For entities that have not yet adopted ASU 2019-12, the tax effect of the changes in tax laws or rates on income taxes receivable (payable) for the current year is recognized in the estimated annual effective tax rate beginning in the interim period which includes the latter of the date the legislation is enacted or effective (including when it is administratively effective). To the extent income taxes receivable (payable) of prior years are adjusted as a result of changes in tax laws or rates, such impacts are recognized in income tax expense (benefit) from continuing operations as of the date of enactment.

The intraperiod tax allocation of the tax effect of changes in tax laws or rates on the measurement of deferred tax assets (liabilities) should be based on enactment date temporary differences and allocated entirely to income tax expense (benefit) from continuing operations. The tax effect of changes in tax laws

or rates on deferred taxes is a discrete event recognized in the interim period that includes the enactment date of the change, even though the changes may not be effective until future periods.

KPMG observation

If this proposal is enacted, entities will need to consider the timing of reversal of temporary differences that exist as of the enactment date. In measuring deferred tax assets (liabilities), existing tax laws and rates should continue to be utilized for temporary differences expected to reverse prior to the effective date. Even though deferred taxes are not generally determined on a daily basis, reasonable effort should be made to estimate such balances at the enactment date.

As a result of the blended rate application for a straddle year, fiscal year-end entities may need to schedule the reversal of enactment date temporary differences to determine which will reverse under existing tax laws, which will reverse in a year that utilizes a section 15 blended rate and which will reverse once the 28% rate is fully effective.

While the adjustments to deferred taxes as a result of changes in tax laws or rates computed using enactment date temporary differences are required to be disclosed, for interim period income taxes calculations, an accounting policy may prescribe which date's temporary differences are used in determining the discrete amount. We believe an entity may determine the discrete amount associated with ordinary income items based on the temporary differences as of either the date of enactment or the amounts at the beginning of the year.

The allocation of income tax expense (benefit) directly to continuing operations may result in residual tax effects within other comprehensive income. Residual tax effects are generally released when the item giving rise to the tax effect is disposed, liquidated or terminated and the release should be consistent with an entity's existing policy on releasing such effects.

Minimum tax on book earnings

The proposal includes a new minimum tax of up to 15% on worldwide pretax book income for large corporations reporting such income in excess of $2.0 billion. Under this proposal, an entity pays an additional income tax over the regular tax liability if the regular tax liability is less than the computed minimum tax. The minimum tax would allow the benefit of general business tax credits (including research, clean energy and housing tax credits) and for foreign tax credits. Taxpayers would also be allowed to claim a credit for minimum tax paid against regular tax in future years but the credit could not reduce that future year's tax liability below the computed minimum tax for that year.

KPMG observation

Entities may need to assess whether the minimum tax on book earnings is considered an incremental tax similar to an alternative minimum tax regime (which would require use of regular tax rates and temporary differences for the measurement of deferred taxes) or if it is considered the primary regime (which would require use of the minimum tax rate and temporary differences for the measurement of deferred taxes). A determination of how to view the minimum tax may not be possible until final legislative language is available.

Global intangible low-tax income (GILTI)

The proposal includes fundamental changes to the GILTI regime. Among other changes to GILTI, the proposal would remove the tax exemption for the first 10% return on foreign assets, requires the GILTI minimum tax to be calculated on a per-country basis (ending the ability of multinationals to shield income from U.S. taxes with taxes paid to higher rate countries), and would increase the GILTI tax rate to 21% (75% of the proposed 28% corporate tax rate) by reducing the section 250 deduction.

In January 2018, the Financial Accounting Standards Board (FASB) staff issued five Staff Q&As addressing various financial accounting and reporting implementation issues related to the legislation known as the TCJA. In one of the Staff Q&As, the FASB staff noted that ASC 740 is not clear as it relates to the accounting for GILTI and established that entities can apply a policy election to either provide deferred taxes related to GILTI or account for taxes on GILTI as a period cost when incurred.

KPMG observation

For entities that have elected to provide deferred taxes related to GILTI, as discussed above, the impact of the changes in tax law are likely to affect the measurement of deferred taxes. The impact should be reflected in the interim period that includes the enactment date and is allocated to income tax expense (benefit) from continuing operations.

If the changes to the GILTI regime are enacted, entities should also analyze the impact of the changes on its valuation allowance assessment. ASC 740 requires an entity to consider all available evidence, both positive and negative, to determine whether based on the weight of that evidence, it has sufficient taxable income to realize its deferred tax assets. An entity may need to reconsider its reliance on future taxable income exclusive of reversing temporary differences as a source of income given the potential GILTI regime changes.

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

The administration's proposal would repeal and replace BEAT with SHIELD, which denies multinational corporations U.S. tax deductions by reference to payments made to financial reporting group members that are subject to a low effective rate of tax. The low effective rate of tax would be defined by reference to the rate agreed upon in multilateral agreements or the default rate of 21% in absence of such agreements. While the majority of the proposed law changes would be effective for tax years beginning after December 31, 2021, the repeal of BEAT and replacement with SHIELD is not proposed to be effective until tax years beginning after December 31, 2022.

KPMG observation

As of the date of enactment of a new proposal, an entity may need to assess whether it has any

deductible temporary differences for expenses accrued to financial reporting group members that would no longer be deductible as a result of SHIELD.

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

The proposal includes new limitations on U.S. interest expense deductions to prevent multinational groups from reducing U.S. tax on income earned from U.S. operations by over-leveraging U.S. operations relative to those operations located in lower-tax jurisdictions. Under the proposal, a financial reporting group member's deduction for interest expense would be limited if the member has net interest expense for U.S. tax purposes and the member's net interest expense for financial reporting purposes exceeds the members proportionate share of the financial reporting group's net interest expense reported on the group's consolidated financial statements. The proposal also includes an alternative where a member can elect for the interest expense deduction to be limited to the member's interest income plus 10% of the member's adjusted taxable income (as defined under section 163(j)). Regardless of whether a taxpayer computes the interest limitation under the proportionate share approach or using the alternative, any disallowed interest expense could be carried forward indefinitely.

A member of a financial reporting group that is subject to the proposal would continue to be subject to the application of section 163(j). Thus, the amount of interest expense disallowed for a tax year of a taxpayer that is subject to both interest expense disallowance provisions would be determined based on whichever of the two provisions imposes the lower limitation.

KPMG observation

As of the date of enactment of a new proposal, an entity will need to consider the impact of the new interest expense disallowance rules, which may result in an increase in future taxable income and the effective tax rate. If an entity anticipates increases in future taxable income as a result of the additional limitation, existing valuation allowance judgments should be reassessed to determine if a change in judgment on the realizability of non-interest related deferred tax assets occurs.

Further, the new limitations (if enacted) may need to be incorporated into the scheduling of the reversal of deferred tax assets in order to determine whether disallowed interest expense carryforwards or interest related temporary differences are realizable. As part of that exercise, if sufficient existing deferred tax liabilities are expected to reverse within the carryforward period to utilize existing disallowed interest carryforwards, including consideration of the annual limitations, a valuation allowance is not appropriate even if the disallowed interest deductions are not expected to be used because the future interest incurred will exceed the amount that is expected to be deductible.

Other considerations

Additional changes included within the proposal may impact an entity's accounting for income taxes, including, but not limited to, the repeal of the FDII deduction, additional support for research and

experimentation expenditures, and eliminating subsidies for fossil fuel companies. Additionally, the proposals include a number of new and expanded credits that include an option to elect a cash payment in lieu of a business tax credit. Once the full details of possible enacted legislation become available of how these credits will operate, entities will need to assess whether they are within the scope of ASC 740 or if they should be accounted for as government assistance.

Financial statement disclosures

KPMG observation

As the administration's proposals move towards proposed or final legislation, entities may need to consider disclosure of the expected effects of enactment in the notes to the financial statements, within management discussion and analysis (MD&A) and/or within risk factors. Within the notes, entities are required to disclose income tax expense (benefit) arising from adjustments of deferred tax assets (liabilities) and income taxes receivable (payable) for changes in tax laws or rates that have been enacted. If the tax law is enacted subsequent to the end of a financial reporting period but prior to the issuance of the financial statements, entities may need to disclose the nature of the event and an estimate of its financial statement effect or a statement that such an estimate cannot be made. Further, to the extent estimated amounts have been recognized, entities may need to provide transparency around the nature of the estimates and the reasonably possible adjustments to those amounts.

Within MD&A, entities may consider disclosing expected future effective tax rates, once there is clarity around which of the proposals will be enacted. Additionally, to the extent future regulatory, administrative or legislative actions could have a materially adverse effect, additional disclosure within risk factors may be necessary.

SEC and FASB considerations

KPMG observation

Shortly after the enactment of the TCJA in 2017, the Securities and Exchange Commission (SEC) staff released Staff Accounting Bulletin No. 118 (SAB 118) which provided that in the period of enactment entities should reflect the income tax effects of items in which the accounting is complete, include provisional amounts for specific income tax effects for which the accounting was incomplete but a reasonable estimate could be determined, or exclude impacts of the change in tax law to the extent a reasonable estimate could not be made. We are not aware of any active initiatives by the SEC staff to provide similar relief as a result of enactment of any legislation coming from the administration's proposals. Accordingly, entities may need to prepare to understand and account for the implications of any changes in tax law in the interim period of enactment.

Further, the FASB staff provided clarification on five topics through Staff Q&As related to the TCJA and the FASB issued ASU 2018-02, Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income, subsequent to enactment covering various matters. At this point, it is not

clear whether any additional guidance or further clarification on the application of accounting literature to changes in tax laws or rates due to the enactment of the proposals will be issued; however, if any guidance is issued, it may not be relied upon until such issuance occurs.

Summary

As noted above, this discussion highlights selective common areas of accounting for income taxes considerations that may be impacted by the administration's proposals, but it is not all inclusive. An entity's specific facts and circumstances should be assessed in determining the accounting for income taxes impact of the proposals.

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	Frederick Campbell-Mohn Sheryl Flum	fcampbellmohn@kpmg.com sflum@kpmg.com	+1 212-954-8316 +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	Manal Corwin Seth Green Danielle Rolfes Ron Dabrowski	mcorwin@kpmg.com sethgreen@kpmg.com drolfes@kpmg.com rdabrowski@kpmg.com	+1 202-533-3127 +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	Mark Price	mhprice@kpmg.com	+1 202-533-4364

products

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	Sharon Katz-Pearlman Mike Dolan	skatzpearlman@kpmg.com mpdolan@kpmg.com	+1 212-872-6084 +1 202-533-6150
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's 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

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

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

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

www.kpmg.com

kpmg.com/socialmedia