Tax Provisions in Biden Administration's FY 2022 Budget Proposals

Healthcare

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KPMG LLP on May 31, 2021, released a 117-page **report** [PDF 1.4 MB] containing analysis and observations of tax proposals in the Biden Administration's FY 2022 budget. For ease of reference, KPMG has compiled summaries and observations relating to certain specific industries and topics in separate reports. This booklet highlights selected revenue proposals that may be of interest to healthcare providers, health insurance companies, and other healthcare-related businesses. For summaries and comments on other aspects of the Biden Administration's proposals, please see our full report at the link above.

This booklet reflects developments and analysis as of July 1, 2021. For information regarding subsequent developments, see ***TaxNewsFlash-Legislative Updates***.

Background

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

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

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

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

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

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

KPMG observation

The Biden Administration has set forth an ambitious long-term infrastructure and social support program. Congress might act on all or part of that program, or could add to it. The revenue-raising tax proposals set out in the budget are designed to offset the cost, over time, of the proposed increases in spending and tax incentives. Some might face challenges in the legislative process and could be modified or eliminated during congressional consideration of possible legislation. Additional proposals could be included in potential legislation as well. Indeed, it would not be surprising if significant modifications were made to the Biden Administration's tax proposals if and when they are considered in Congress.

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Corporate

Raise the corporate income tax rate to 28%

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

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.

In addition to its application to taxable healthcare organizations, the proposed increased rate presumably would apply to unrelated business taxable income earned by tax-exempt health systems and would also be the rate for the excise tax under section 4960 on compensation over $1 million paid by tax-exempt employers to certain covered employees.

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** discussion in KPMG's report dated May 31, 2021 and the **Replace BEAT with SHIELD rule** section 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 seems 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' incentives 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

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

The administration's proposal would repeal the Base Erosion and Anti Abuse Tax ("BEAT") and replace it with the "Stopping Harmful Inversions and Ending Low-Tax Developments "(SHIELD") regime. The stated intent of the proposal is to address - more effectively than BEAT - concerns regarding erosion of the US corporate tax base, while simultaneously providing a strong incentive for other jurisdictions to adopt the income inclusion rule (IIR) that is currently being developed at the OECD as part of Pillar Two or alternatively for low-tax jurisdictions to implement or strengthen their own corporate tax regimes. (For a discussion of the interactions of the Green Book proposals with the ongoing negotiations at the OECD on Pillars One and Two, see KPMG's **May 31, 2021 report** [PDF 1.4 MB].)

Mechanics of SHIELD—In general

SHIELD would disallow deductions of domestic corporations or branches, and would apply to any financial reporting group that (1) includes at least one domestic corporation, domestic partnership, or foreign entity with a US trade or business, and (2) has more than $500 million in global annual revenues, as determined based on the group's consolidated financial statement. A financial reporting group, for these purposes, would be any group of business entities that prepares consolidated financial statements in accordance with U.S. Generally Accepted Accounting Principles (GAAP), International Financial Reporting Standards (IFRS), or another method authorized by regulations.

Deductions would be disallowed when both of the following conditions are satisfied: (1) the financial reporting group contains one or more "low taxed members" and (2) the domestic corporation or branch makes any gross payment to any member of the financial reporting group.

KPMG observation

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

KPMG observation

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

For purposes of SHIELD, a "low-taxed" member is any financial reporting group member whose income is subject to (or deemed subject to) an ETR (the "SHIELD ETR") that is below a "designated minimum tax rate." The "designated minimum tax rate" would be the rate agreed under Pillar Two. However, if SHIELD is in effect before an international agreement on Pillar Two is reached, the designated minimum rate would be the proposed rate for GILTI (21%).

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

KPMG observation

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

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

Disallowed deductions—Determination

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

For purposes of step (i), a payment made directly to a low-taxed member is subject to SHIELD in its entirety (the "Direct Payments Rule"). In the case of a payment to a member that is not low-taxed, a portion of the payment is deemed to be made to the low-taxed member(s), based on the ratio of the financial reporting group's low-taxed profits over the group's total profits, determined using the group's consolidated financial accounts (the "Indirect Payments Rule"). For purposes of this step, "payments" (whether under the Direct Payments Rule or Indirect Payments Rule) are not limited to deductible payments, and instead include all gross payments, including, for example, payments included in COGS.

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

KPMG observation

The SHIELD's proposed full deduction disallowance under the Direct Payments Rule is a significant (and very taxpayer unfavorable) departure from the OECD's UTPR proposed "top-up" mechanism, which would deny a proportionate amount of a deduction in the payor jurisdiction by reference to the difference between the minimum rate and the Pillar Two ETR of the relevant jurisdiction.

KPMG example

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

KPMG observation

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

KPMG example

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

Exceptions and exemptions

The proposal does not indicate that any exceptions would apply based on the type of payment. The proposal also would provide authority for Treasury to exempt payments of financial reporting groups that meet a minimum effective level of taxation on a jurisdiction-by-jurisdiction basis, as well as payments to domestic and foreign investment funds, pension funds, international organizations, or nonprofit entities. Treasury also would be expected to write rules to take into account payments by partnerships.

Taxation of high-income taxpayers

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.

Both the NIIT and SECA proposals could increase the tax liability of physicians and other individual owners of physician practices and healthcare partnerships whose owners' income exceeds the threshold limits described above.

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 the American Rescue Plan Act (ARPA) earlier this year, 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.

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.

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.

Improve tax administration

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.

Tax-Exempt Organizations

For a discussion of the potential impact of some of the tax proposals in the Green Book on tax-exempt organizations, see KPMG's ***TaxNewsFlash*** on *Tax Proposals in Biden Administration's FY 2022 budget, only indirect impact for exempt organizations*.

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