“Build Back Better Act” tax proposals, as approved by Ways and Means

KPMG summary and analysis

NOTE: This report reflects developments as of 9:00 AM EDT on September 16, 2021.

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This report provides a summary and analysis of many of the legislative tax proposals released, marked up, and approved by the House Ways and Means Committee as part of its consideration of recommendations for budget reconciliation legislation. These proposals are part of a larger legislative effort by the Ways and Means Committee to contribute to the Build Back Better Act moving through the House. The Ways and Means Committee recommendations will be packaged together with recommendations from other committees for subsequent consideration by the House, with changes possible before House action.

Background

The Biden Administration

President Biden has called on Congress to provide trillions of dollars in funding for investment in infrastructure. This call for investment includes investment in “hard infrastructure” such as transportation, energy, broadband, and other traditional categories of investment. But President Biden has also called for significant funding for what the administration calls “human infrastructure.” This category of investment includes payments to low- and middle-income families, training programs, education subsidies, caregiving assistance, and other policy priorities.

At the same time, the Biden Administration has suggested several ways to offset the cost of these investments. These offsets include a number of proposed tax increases for many businesses and wealthy individuals. The administration’s tax plan (both tax cuts and tax increases) was described in full in the May release of the so-called “Green Book” [PDF 884 KB] (114 pages). Read KPMG’s report about the tax proposals in the Green Book: KPMG report: Analysis and observations of tax proposals in Biden Administration’s FY 2022 budget [PDF 1.4 MB] (118 pages)

In total, the Biden Administration has called this effort for both spending and tax increases the Build Back Better Plan.

The Congress

It is now for Congress to advance the president’s agenda through the legislative process and to deliver legislation to the White House for signature and enactment. The Senate has already approved approximately $550 billion in new infrastructure spending and has done so on a bipartisan basis. That bipartisan bill awaits action in the House of Representatives.

The House has now begun action on a second, larger bill, the Build Back Better Act. This bill has components spread across the jurisdiction of multiple committees and is both more ambitious and more controversial than the bipartisan bill already approved by the Senate. The Build Back Better Act is unlikely to get Republican support in Congress, leaving Democrats to move the bill alone. This requires Democrats to use the budget reconciliation process, as detailed below, to move the legislation through the narrowly divided Congress.

The Ways and Means Committee

The legislation has a very substantial tax title as put forward by the House Committee on Ways and Means. Ways and Means successfully reported this tax title out of committee on September 15, after
previously approving several other titles addressing other matters in its jurisdiction as well as a title that included some retirement savings tax incentives.

The Committee-approved legislation is enormous, with the tax proposals alone totaling more than 885 pages of legislative text and recommending more than a trillion dollars in tax cuts and spending and more than two trillion dollars in gross tax increases. The proposed legislation would deliver tax benefits to an array of taxpayers and activities, including benefits for green energy investment, housing, other infrastructure, and for various social programs.

To offset the costs of these tax benefits, the bill also includes a large number of tax increases targeted at cross border activity, and many corporations, passthrough businesses, and wealthy individuals, to name a few. A summary of these items follows, followed by a detailed description in the body of this report.

### Tax incentives and tax benefits provisions

The tax incentive and benefit proposals included in the Ways and Means recommendations include tax credits and incentives for infrastructure financing, green energy, the social safety net, and drug pricing. According to the Committee’s press release, the proposals are intended to:

- Support clean energy investment and deployment, and the creation of good, well-paying jobs
- Extend the American Rescue Plan expansion of the child tax credit, and make permanent the American Rescue Plan expansions of the earned income tax credit and the child and dependent care tax credit
- Reinstate Build America Bonds and advanced refunding bonds to provide financing to state and local governments and spur investment in the private sector
- Expand tax credit programs that encourage economic and affordable housing investments in our communities that are most in need
- Lower prescription costs for Americans by allowing the HHS Secretary to negotiate for lower drug prices
- Provide immediate coverage for Americans in the Medicaid coverage gap
- Extend the American Rescue Plan’s expanded premium tax credits to help lower health insurance costs

These proposals fall into three main categories:

- **Infrastructure financing.** Proposals addressing issues including New Markets Tax Credit permanency, expansion of the Rehabilitation and Low-Income Housing Tax Credits, a new Neighborhood Homes credit, and infrastructure financing.

- **Green energy.** Proposals to extend and modify the credits for renewable electricity production and for renewable fuels, extend and modify green energy and efficiency incentives for individuals, and extend and modify incentives for electric and alternative fuel vehicles.

- **Social safety net.** Proposals to extend and expand the refundable child credit, modify the Child and Dependent Care Credit and Earned Income Tax Credit, and create tax credits to support childcare providers.

The revenue cost of these proposals, according to the Joint Committee on Taxation (JCT), would be
about $1.2 trillion, not including the non-tax health care provisions.

## Tax revenue and reform provisions

The tax increase proposals include corporate and business, international, and individual tax increases, and other changes. The goals of these proposals, in addition to offsetting the cost of spending and tax benefits of the Build Back Better Act, were outlined in a release by Ways and Means Committee Chairman Neal:

- Mitigate wealth inequality and strengthen the progressive power of our tax system by increasing the individual tax rate, increasing the top capital gains rate, and adding a modest surtax on the highest-income taxpayers
- Level the playing field by cutting taxes for our nation’s smallest businesses and bringing the corporate rate to 26.5%
- Promote global competitiveness while ensuring that multinational corporations pay their fair share by better harmonizing the U.S. corporate minimum tax rate with the rate agreed to by over 130 countries in international negotiations
- Invest in tax fairness by better equipping the IRS with updated technology and the human capital necessary for the complex audits of high-wealth individuals

According to the JCT, these proposals are estimated to raise approximately $2.07 trillion over 10 years. Together with analysis of revenue raised by improved compliance from increased funding for the Internal Revenue Service (IRS), macroeconomic effects, and estimates of cost savings related to drug pricing, these proposals are intended to offset fully the $3.5 trillion potential 10-year cost of the Build Back Better Act, as contemplated by the budget resolution.

The revenue-raising proposals include:

- Increasing the top corporate rate to 26.5%
- Limiting the interest deduction of domestic corporations that are part of an international financial reporting group
- International tax changes, including:
  - Reductions in the deductions for GILTI (to 37.5%) and FDII (to 21.875%)
  - Country-by-country application of the GILTI regime
  - Reduction of the allowable net deemed tangible income return from 10% to 5%
  - Determination of foreign tax credit limitations on a country-by-country basis
  - Increase from 80% to 95% the deemed paid credit for taxes attributable to GILTI
  - Substantial modification of the BEAT rate and determination
- Increasing the top marginal individual rate to 39.6%
- Imposing a new 3% tax on modified adjusted gross income above $5 million
- Increasing the capital gains rate to 25% effective on the date of introduction
- Expanding net investment income tax to trade or business income of high-income individuals
- Imposing an income limitation on the section 199A deduction for qualified business income
- Making permanent the section 461(l) disallowance of excess business losses
- Significantly modifying the rules applicable to grantor trusts
• Imposing limits on individual retirement plans of high-income taxpayers with large account balances
• Advancing five years the section 162(m) limitation on the deduction of excessive employee remuneration for highly-compensated employees
• Delaying for four years the effective date for amortization of research and experimentation expenditures (a taxpayer favorable change)

KPMG observation
The Committee-approved legislation does not include any change in the limit on the state and local tax deduction for individual taxpayers enacted in the 2017 Tax Act. Chairman Neal, however, indicated in a joint statement with Reps. Pascrell (D-NJ) and Souzzi (D-NY) that he is committed to providing relief from the “short-sighted capping of SALT.”

Documents
The Ways and Means Committee released proposed statutory language for its proposals before the beginning of the markup. Committee staff also prepared short section-by-section summaries. The staff of the JCT also issued detailed technical explanations of the revenue proposals as well as revenue estimates.

• Read TaxNewsFlash (September 14, 2021)
• Read TaxNewsFlash (September 13, 2021)
• Read TaxNewsFlash (September 11, 2021)

KPMG observation
The expected legislative process accelerated significantly after the Senate passed the bipartisan infrastructure bill in late August, prompting demands by some House Democrats for an immediate vote on that legislation (which includes part, but far from all of the president’s Build Back Better proposals). Perhaps as a result of the extremely quick movement of the proposals through Ways and Means, there are differences between the proposed statutory language and the JCT technical explanation in some places. These differences beg the question of what the lawmakers actually intended and might be addressed as the legislative progress continues to move forward.

Budget reconciliation
Adoption of the Senate-passed budget resolution by the House on August 11, 2021, initiated the Congressional budget reconciliation process. That process, among other things, would permit passage of a budget reconciliation bill in the Senate by a simple majority, effectively avoiding the usual requirement that there for 60 votes to end debate, i.e., a filibuster. Congressional Democrats have initiated the process with the expectation of universal Republican opposition to the proposed tax increases, as well as many of the spending proposals and the potential increase in the deficit.
Limitations on the budget reconciliation process may affect some of the proposals being considered. In particular, Senate rules require that every provision in a budget reconciliation bill must have more than an incidental effect on spending and revenue. Provisions that create new policy may not satisfy that requirement.

In addition, the narrow Democratic majorities in the House, the “50-50” Senate, and the resulting need for near unanimous bi-chamber Democratic support for a reconciliation bill could complicate passage.

The budget resolution approved by the House and Senate allows for up to $3.5 trillion in new spending. It provides instructions to the various Congressional committees setting net spending limits within their jurisdictions. Their charge is to produce recommendations for conforming legislation, which is to be reported to the House Budget Committee; the Budget Committee then assembles the various pieces of legislation into the reconciliation bill. The budget resolution directs the committees to report their legislation to the Budget Committee by September 15, although that direction is not binding.

The instruction to the House Ways and Means Committee is to produce recommendations that raise at least $1 billion in revenue over 10 years. The Committee is therefore required to offset the cost of the spending provisions it approved, including the tax incentive and benefit provisions – and to raise an additional $1 billion, a small amount given the scale of the overall package. The legislation approved by the Committee would fulfill that directive.

What's next?

With the legislation now approved by the Ways and Means Committee, a number of other procedural steps are required before the full House can approve the legislation.

First, the Budget Committee must take the legislation approved by the various committees of jurisdiction and combine them into a single bill. Next, the combined bill would move through the Rules Committee where rules governing the debate, consideration of the bill, and amendments will be set.

Democratic leadership is trying to move the Build Back Better proposals through both chambers of Congress before the end of the month—a very ambitious deadline—or at least to ensure by that time that the legislation is in a shape that could secure virtually every Democratic vote in the House and all Democratic votes in the Senate. Thus, it is possible that major changes could be made before the House votes on the legislative proposals.

Assuming the legislation successfully moves through these steps, it would then be transmitted to the Senate for consideration in that body. The Senate is then free to approve the House bill or, more likely, make its own changes. The House and the Senate would then begin a process of reconciling the differences between their two bills. The nature of these possible changes, or the precise timing for consideration are unknown at this time, notwithstanding Congressional leadership’s goal of moving the legislation extremely quickly.

This report is organized as follows:
Contents

Infrastructure financing .......................................................................................................................... 10

- New Markets Tax Credit made permanent .................................................................................... 10
- Rehabilitation tax credit .................................................................................................................... 10
- Disaster and resiliency ...................................................................................................................... 12
  - Exclusion of amounts received from state-based catastrophe loss mitigation programs ........ 12
  - Repeal of temporary limitation on personal casualty losses ....................................................... 12
  - Credit for qualified wildfire mitigation expenditures ................................................................. 13
- Housing ................................................................................................................................................ 13
  - Low-income housing tax credit ..................................................................................................... 13
  - Neighborhood homes investment tax credit .................................................................................. 16
- Bonds .................................................................................................................................................. 18
  - Credit to issuer for certain infrastructure bonds .......................................................................... 18
  - Advance refunding bonds .............................................................................................................. 21
  - Permanent modification of small issuer exception to tax-exempt interest expense allocation rules for financial institutions ................................................................. 22
  - Modifications to qualified small issue bonds .............................................................................. 23
  - Expansion of certain exceptions to the private activity bond rules for first-time farmers .......... 25
  - Certain water and sewage facility bonds exempt from volume cap on private activity bonds ...... 26
  - Exempt facility bonds for zero-emission vehicle infrastructure ................................................ 27
  - Application of Davis-Bacon Act requirements with respect to certain exempt facility bonds .... 28
  - Tax-exempt bond financing requirement ..................................................................................... 29
- Investments in tribal infrastructure ..................................................................................................... 30
  - Treatment of Indian tribes as states with respect to bond issuance ............................................ 30
  - NMTC for tribal statistical areas .................................................................................................... 33
  - Inclusion of Indian areas as difficult development areas .............................................................. 33
- Investments in the territories .............................................................................................................. 33
  - Possessions economic activity credit ........................................................................................... 33
  - Additional NMTC allocations for the territories ........................................................................... 34

Green energy ........................................................................................................................................ 34

- Renewable electricity and reducing carbon emissions ................................................................. 34
  - Extension of credit for electricity produced from certain renewable resources and extension and modification of the energy tax credit ................................................................. 34
  - Increase in energy credit for solar facilities placed in service in connection with low-income communities........................................................................................................... 37
  - Elective payment for energy property and electricity produced from certain renewable resources, etc. ........................................................................................................................................... 38
  - Investment credit for electric transmission property .................................................................... 40
  - Zero emissions facility credit ........................................................................................................ 41
  - Extension of credit for carbon oxide sequestration ..................................................................... 42
  - Green energy publicly traded partnerships .................................................................................. 43
  - Zero-emission nuclear power production credit .......................................................................... 45

Renewable fuels .................................................................................................................................. 45

- Extend tax incentives for biodiesel (including renewable diesel), agri-biodiesel, biodiesel mixtures, alternative fuel, and alternative fuel mixtures ........................................................................ 45
- Extend tax incentives for second generation biofuel ...................................................................... 45
Provide tax incentives for sustainable aviation fuel ................................................................. 46
Green energy and efficiency incentives for individuals ................................................................. 49
Extension, increase, and modifications of nonbusiness energy property credit ................................. 49
Residential energy efficient property ............................................................................................ 49
Energy efficient commercial buildings deduction ........................................................................ 50
Extension, increase, and modifications of new energy efficient home credit .................................. 51
Modifications to income exclusion for conservation subsidies .................................................... 51
Greening the fleet and alternative vehicles ..................................................................................... 52
Refundable new qualified plug-in electric drive motor vehicle credit for individuals (section 136401) ................................................................. 52
Credit for qualified commercial electric vehicles ........................................................................... 53
Qualified fuel cell motor vehicles ................................................................................................ 54
Alternative fuel refueling property credit ....................................................................................... 54
Reinstatement and expansion of employer-provided fringe benefits for bicycle commuting .......... 55
Credit for certain new electric bicycles ............................................................................................ 55
Investment in the green workforce ................................................................................................ 55
Extension of the advanced energy project credit ........................................................................... 55
Qualified environmental justice program credit ............................................................................. 56
Reinstatement of Superfund excise taxes on crude oil and imported petroleum products ................. 57
Social safety net ........................................................................................................................................ 58
Child tax credit ........................................................................................................................................ 58
Modifications to child tax credit applicable beginning in 2021 .......................................................... 58
Extension and modification of child tax credit and advance payment for 2022 ................................. 58
Establishment of monthly child tax credit with advance payment through 2025 .............................. 61
Refundable child tax credit after 2025 ............................................................................................... 63
Child and dependent care tax credit .................................................................................................. 63
Certain improvements to the child and dependent care credit made permanent .............................. 63
 Increase in exclusion for employer-provided dependent care assistance made permanent ............... 65
Supporting caregivers ......................................................................................................................... 65
Payroll tax credit for child care workers ............................................................................................ 65
Credit for caregiver expenses ............................................................................................................. 66
Earned income tax credit .................................................................................................................. 66
Expanding access to health coverage and lowering costs ............................................................... 67
 Make permanent the American Rescue Plan expansion of premium tax credits .................................. 67
 Modify employer-sponsored coverage affordability test for PTC eligibility ...................................... 68
 Exclude lump-sum social security benefits from determining PTC eligibility ..................................... 68
 Temporarily expand PTC eligibility for certain low-income populations ........................................... 69
 Modify special premium tax credit rules for those receiving unemployment compensation ............ 69
 Make permanent the credit for health insurance costs ..................................................................... 70
Pathway to Practice medical school scholarship program ................................................................. 70
Higher education ............................................................................................................................... 70
Public university research infrastructure credit ................................................................................ 70
Modification of excise tax on investment income of private colleges and universities ...................... 71
Treatment of Federal Pell grants for income tax purposes ................................................................. 72
Repeal of denial of American Opportunity Tax Credit on basis of felony drug conviction ................... 72
Drug pricing ......................................................................................................................................... 73
Drug price negotiation program and excise tax ................................................................................ 73
Previously approved retirement savings proposals .............................................................................. 73
Automatic contribution plans and arrangements .............................................................................. 73
Surcharge on high-income individuals, trusts, and estates ................................................................. 160
Termination of temporary increase in unified credit ............................................................................ 161
Increase in limitation on estate tax valuation reduction for certain real property used in farming or other trades or businesses ........................................................................................................ 162
Certain tax rules applicable to grantor trusts ...................................................................................... 163
Valuation rules for certain transfers of nonbusiness assets ................................................................. 167
Modification of rules relating to retirement plans .................................................................................. 168
Contribution limit for individual retirement plans of high-income taxpayers with large account balances ........................................................................................................................................ 168
Increase in minimum required distributions for high-income taxpayers with large retirement account balances ................................................................................................................................ 168
Tax treatment of rollovers to Roth IRAs and accounts .......................................................................... 169
Prohibition of IRA investments conditioned on account holder’s status .............................................. 170
Statute of limitations with respect to IRA noncompliance ..................................................................... 170
Prohibition of investment of IRA assets in entities in which the owner has a substantial interest .................................................................................................................................................. 171
IRA owners treated as disqualified persons for purposes of prohibited transaction rules .................. 171
Funding of the IRS and improving compliance ....................................................................................... 172
Funding the IRS ....................................................................................................................................... 172
Backup withholding and third party networking .................................................................................... 173
Modify requisite supervisory approval for penalty assessments .............................................................. 175
Other proposals ...................................................................................................................................... 176
Modifications to limitation on deduction of excessive employee remuneration ......................................... 176
Extension of tax to fund Black Lung Disability Trust Fund ..................................................................... 177
Prohibited transactions relating to holding DISC or FSC in individual retirement account ................... 177
Increase in tax on certain tobacco products and imposition of tax on nicotine ........................................ 177
Clarification of tobacco drawback rules ................................................................................................. 179
Repeal employer credit for paid family and medical leave .................................................................... 179
Access to self-employment income information for paid leave administration ...................................... 180
Temporary rule to allow certain S corporations to reorganize as partnerships without tax .................... 180
Treatment of certain qualified sound recording productions ................................................................ 182
Payment to certain individuals who dye fuel .......................................................................................... 183
Extension of credit for portion of employer Social Security taxes paid with respect to employee tips to beauty service establishments ......................................................................................... 183
Enhancement of work opportunity tax credit during COVID-19 recovery period .................................... 183
Allowance of deduction for certain expenses of the trade or business of being an employee (union dues) ........................................................................................................................................... 184
Repeal limitation on cover over of rum taxes to Puerto Rico and U.S. Virgin Islands .............................. 184
Delay in mandatory capitalization of research and experimentation costs ............................................ 185
Payroll credit for compensation of local news journalists ...................................................................... 185
Treatment of financial guaranty insurance companies as qualifying insurance corporations under passive foreign investment company rules ........................................................................... 186
Credit for qualified access technology for the blind ................................................................................ 187
Modification of REIT constructive ownership rules ................................................................................ 187
State and local tax implications ............................................................................................................... 188
Impact of the proposals on accounting for income taxes ......................................................................... 193
Infrastructure financing

New Markets Tax Credit made permanent

The proposal would make the new markets tax credit (NMTC) permanent. In addition, for NMTC allocation limitations in calendar years 2022 and 2023, there would be additional allocation amounts of $2 billion (for a total of $7 billion in 2022) and $1 billion (for a total of $6 billion in 2023). Allocation amounts would be set at $5 billion for 2024 and all years thereafter. Beginning in 2024, the proposal would index the annual allocation amount to inflation. These proposal amendments would be effective for NMTC allocation limitations determined for calendar years after 2021.

The proposal would add the NMTC as a specified credit under the general business credit provisions that can be used against the alternative minimum tax (AMT) but only with respect to credits relating to qualified equity investments made after December 31, 2021.

The JCT has estimated that the proposal would lose approximately $2.316 billion over a 10-year period. For calendar years after 2021, in addition to the above increased NMTC allocation limitations, the proposal would create a new, permanent, annual $175 million NMTC allocation for low-income communities in tribal statistical areas and broadens the definition of low-income community to include an area used for a project which services a significant population of Tribal or Alaska Native Village members who are residents of a low-income community.

The JCT has estimated that the proposal would lose approximately $226 million over a 10-year period.

Also, a new, permanent, annual $100 million NMTC allocation would be created for low-income communities in U.S. territories. 80% of the such allocation would be directed towards projects in Puerto Rico, and 20% directed towards projects in Guam, the Commonwealth of the Northern Marian Islands, the U.S. Virgin Islands, or American Samoa. The new tribal and U.S. territories allocation amounts would be indexed for inflation beginning in 2024. These proposal amendments would be effective for NMTC determined for calendar years after December 31, 2021.

The JCT has estimated that the proposal would lose approximately $2.3 billion over a 10-year period.

KPMG observation

Making the NMTC permanent would be the foremost enhancement to the credit and would provide greater assurance to investors considering investing in riskier low-income communities. Increasing the annual credit limitation and indexing such amounts for inflation would increase the amount of investment dollars available for projects seeking NMTC financing in underserved economic areas across the United States and its territories. Increasing NMTC allocation authority for tribal statistical areas, Puerto Rico, and the other U.S. territories would drive more investment in such areas and allow qualified businesses in those areas greater participation in the NMTC program.

Rehabilitation tax credit

Under current law, a 20% tax credit is provided for qualified rehabilitation expenditures (the HTC) with
respect to a certified historic structure. The HTC is generally allowable ratably in each tax year over the five-year period beginning in the tax year in which the qualified rehabilitated building is placed in service, for amounts paid or incurred after December 31, 2017.

The proposal would modify the HTC by replacing the current 20% with an applicable percentage applied for tax years beginning before 2020 equal to 20% and 30% for tax years 2020 through 2025. The applicable percentage would be phased down to 26% in 2026, 23% in 2027, and returns to 20% in 2028 and thereafter. The temporary credit rate increase would be effective for property placed in service after March 31, 2021.

For certain smaller projects, the proposal would provide an applicable percentage of 30% for qualified rehabilitation expenditures (QREs) capped at $2,500,000. A smaller project is defined generally as a qualified rehabilitated building for which the QREs do not exceed $3,750,000, and for which no rehabilitation credit was allowed for the two tax years preceding the first year for which such expenditures are paid or incurred. Taxpayers may elect between the regular HTC and the small project credit. The elective credit rate increase for smaller projects is effective for tax years beginning after December 31, 2021.

The proposal would modify the substantial rehabilitation requirement so that QREs must exceed the greater of (1) 50% (instead of the current 100%) of the adjusted basis of the building (and its structural components), or (2) $5,000. The modification of the substantial rehabilitation requirement would be effective for 24-month (or 60-month) periods ending after December 31, 2021.

The proposal would also remove the requirement that the QREs be reduced by the amount of the HTC and, in the case of a lease passthrough arrangement in which the HTC is passed through to the lessee, the proposal would eliminate the requirement that the lessee must include ratably in gross income over the shortest recovery period with respect to such property an amount equal to 100% of the HTC. These proposal amendments would be for QREs placed in service after December 31, 2022.

The proposal would modify the tax-exempt use property rules for the HTC by amending the disqualified lease rules, making such rules only applicable in the case of a government entity and would be effective for leases entered into after December 31, 2021.

Also, the tax-exempt use rules would not apply in the case of the rehabilitation of any building that was used as a qualified public educational facility as defined under section 142(k)(1) at any time during the five-year period ending on the date that such rehabilitation begins and which is used as such a facility immediately after such rehabilitation. The proposal amendment would be effective for property placed in service after December 31, 2021.

The JCT has estimated that the proposal would lose approximately $26.476 billion over a 10-year period.
Disaster and resiliency

Exclusion of amounts received from state-based catastrophe loss mitigation programs

The proposal would provide an exclusion from gross income for certain state-based grants made to homeowners that support mitigation efforts for earthquakes, fires, windstorms, and other disasters.

The exclusion would apply to tax years beginning after December 31, 2020.

The JCT estimated that the provision would decrease revenues by approximately $122 million over 10 years.

Repeal of temporary limitation on personal casualty losses

The proposal would repeal the TCJA’s temporary limitation on personal casualty losses and extend the period of time individuals have to claim losses attributable to damages resulting from deteriorating concrete foundations containing pyrrhotite.

The TCJA limited the deduction that could be claimed for personal casualty and theft losses not compensated by insurance or otherwise to personal casualty and theft losses incurred in a federally declared disaster for tax years 2018 through 2025.

The proposed repeal of the TCJA’s temporary limitation on personal casualty and theft losses would apply to losses incurred in tax years beginning after December 31, 2017, meaning individual taxpayers may be eligible to amend their tax returns for tax years 2018 through 2020 to claim previously disallowed losses.

The proposal would also extend the period of time individuals have to make a claim for credit or refund attributable to a casualty loss deduction for amounts paid to repair damage to their personal residences caused by deteriorating concrete foundations containing pyrrhotite. Under the proposal, the statute of limitations for making a claim of credit or refund for this type of casualty loss arising in tax years beginning after December 31, 2016 would expire no earlier than one year after the date of the enactment of this proposal.

The JCT estimated that the provision would decrease revenues by approximately $2 billion over 10 years.
KPMG observation

The proposed repeal of the TCJA provision limiting personal casualty and theft loss deductions solely to those incurred in a federally declared disaster would expand the scope of personal property loss deductions available to individual taxpayers. Under the broader pre-TCJA definition, such losses could include personal casualty losses resulting from fires, floods, or storms that occur in areas not subject to a federal disaster declaration or other sudden or unexpected events such as theft or an automobile collision.

Credit for qualified wildfire mitigation expenditures

The proposal would create a tax credit equal to 30% of qualified expenditures for individuals and businesses who participate in a qualified state-based wildfire resiliency program.

The provision would apply to expenditures paid or incurred after the date of enactment, in tax years ending after that date.

The JCT estimated that the provision would decrease revenues by approximately $387 million over 10 years.

Housing

Low-income housing tax credit

The proposal would make several changes to the low-income housing credit (LIHTC).

Increases in state housing credit ceilings

The proposal would modify the population component of the State housing credit ceiling. For 2022, the population component of the state housing credit ceiling would be equal the greater of (1) $3.22 multiplied by the state population, or (2) $3,711,575. For 2023, the population component of the State housing credit ceiling would equal the greater of (1) $3.70 multiplied by the state population, or (2) $4,269,471. For 2024, the population component of the State housing credit ceiling would be equal to the greater of (1) $4.25 multiplied by the state population, or (2) $4,901,620. For 2025, the population component of the State housing credit ceiling would be equal to the greater of (1) $4.88 multiplied by the state population, or (2) $5,632,880. These amounts are adjusted for inflation in calendar years 2026, 2027, and 2028.

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

The JCT has estimated that the proposal would lose approximately $11.04 billion over a 10-year period.

Tax-exempt bond financing requirement

Currently, the 4% housing credit provides a credit from the state private activity bond volume cap when 50% or more of the building and land is financed by tax-exempt bonds. The proposal would temporarily reduce the 50% requirement to 25% for buildings financed by the proceeds of tax-exempt bonds issued in any calendar year 2022-2028 (and not by any obligation taken into account during any tax year

(See further discussion below in bond financing discussion.)

The JCT has estimated that the proposal would lose approximately $9.498 billion over a 10-year period.

**Buildings designated to serve extremely low-income households**

The proposal would add a new state housing allocation set-aside requirement for certain buildings with extremely low-income households requiring that at least 10% of the state housing credit ceiling be allocated to certain buildings with extremely low-income households.

A building with extremely low-income households is a building when 20% or more of the residential units are rent-restricted (determined as if the imputed income limitation applicable to such units were 30% of area median gross income), which have been designated by the taxpayer for occupancy by households the aggregate household income of which does not exceed the greater of (1) 30% of area median gross income, or (2) 100% of an amount equal to the Federal poverty (“extremely low-income buildings”). The requirements of the new set-aside would not apply to allocations after December 31, 2031.

The proposal also makes certain extremely low-income buildings eligible for enhanced low-income housing tax credit. For any extremely low-income building which is designated by the state housing credit agency as requiring an increase in credit in order for the building to be financially feasible, such building’s eligible basis would be increased to 150% of the otherwise applicable eligible basis. The enhanced credit would not available for allocations made after December 31, 2031

The JCT has estimated that the proposal would lose approximately $2.603 billion over a 10-year period.

**Inclusion of rural areas as difficult development areas**

The proposal would allow states the ability to provide an enhanced credit of up to 130% for projects in rural areas if needed for financial feasibility, by qualifying rural areas as difficult development areas. Rural areas are defined as any non-metropolitan area or any open country, place, town, village, or city which is not part of or associated with an urban area and either has low population or is not contained within a standard metropolitan statistical area and has a serious lack of mortgage credit for lower and moderate income families, as determined by the Secretary of Agriculture and the Secretary of Housing and Urban Development and which is identified by the qualified allocation plan of the housing credit agency. The proposal would apply to buildings placed in service after December 31, 2021.

The JCT has estimated that the proposal would lose approximately $2.654 billion over a 10-year period.

**Repeal of qualified contract option**

The proposal would eliminate the qualified contract exception for buildings receiving allocations after January 1, 2022. The qualified contract exception allows an owner of a qualified low-income building to submit a written request beginning on the date after the 14th year in the compliance period, that the state housing agency find a qualified buyer to acquire the owner’s building within a one-year period from the date of such request. If the state is unable to find a qualified buyer, the building’s extended use period terminates, and the housing affordability restrictions are removed.

Specifically, the proposal would limit the use of the exception to (1) buildings that received housing credit allocations before January 1, 2022, or (2) with respect to buildings financed with tax-exempt bonds, buildings that received housing credit allocations before January 1, 2022, a determination from the issuer of the tax-exempt bonds or the housing credit agency that the building has satisfied the qualified...
allocation plan requirements and the financial feasibility determination.

In addition, for buildings that may still make use of the qualified contract exception, the proposal would modify the specified statutory price. The price for any non-low-income portion remains the fair market value. The price for the low-income portion is the fair market value, determined by the housing credit agency taking into account the rent restrictions required to continue to satisfy the minimum set aside requirements. The Secretary is directed to prescribe regulations necessary or appropriate to the determination of the specified statutory price. The proposal would generally be effective on the date of enactment. The proposal to modify the specified statutory price would apply to buildings with respect to which the building owner submits, after the date of enactment, a written request to find a buyer that agrees to acquire the owner’s interest in the low-income portion of the building.

The JCT has estimated that the proposal would raise approximately $466 million over a 10-year period.

**Modification and clarification of rights relating to building purchase**

Currently, no federal income tax benefit shall fail to be allowable to the taxpayer with respect to any qualified low-income building merely by reason of a right of first refusal held by the tenants or resident management corporation of such building or by a qualified nonprofit organization or government agency to purchase the property after the close of the compliance period for a price which is not less than a certain purchase price.

The proposal would modify this right of first refusal safe harbor into an option safe harbor. In addition, for existing agreements, the provision clarifies, for purposes of the safe harbor, that the right to acquire the property includes the right to acquire the property or all the partnership interests relating to the building. It also clarifies that the right to acquire the building includes the right to acquire assets held for the development, operation, or maintenance of the building. Thus, agreements which provide for the right to acquire these partnership interests or building assets would satisfy the safe harbor.

The proposal also would clarify that, for existing agreements, the right of first refusal safe harbor may be satisfied by the grant of an option. A right of first refusal may be exercised in response to an offer by a related party; a bona fide third-party offer is not needed. A right of first refusal may be exercised without the approval of any owner of a credit project.

Finally, the proposal would amend the minimum purchase price to exclude exit taxes. The new definition of the minimum purchase price would be the principal amount of outstanding indebtedness secured by the building (other than indebtedness incurred within the five-year period ending on the date of the sale to the tenants). In the case of a purchase of a partnership interest, the minimum purchase price would be an amount not less than such interest’s ratable share of the principal amount of outstanding indebtedness secured by the building (other than indebtedness incurred within the five-year period ending on the date of the sale to the tenants). Thus, agreements that do not include exit taxes as part of the minimum purchase price do not fail to satisfy the safe harbor.

The proposal that would change the right of first refusal safe harbor into an option safe harbor is effective for agreements entered into or amended after the date of enactment. The other provisions of the proposal would be effective for agreements entered into before, on, or after the date of enactment.

The JCT has estimated that the proposal would raise approximately $751 million over a 10-year period.

**Increase in credit for bond-financed projects designated by housing credit agency**

The proposal would modify the rule which treats as difficult development areas those buildings
designated by state housing agencies as requiring an increase in credit. Under the proposal, buildings so designated and financed with the proceeds of tax-exempt bonds would be treated as located in difficult development areas for purposes of determining eligible basis provided the determinations of housing credit dollar amounts are not made after December 31, 2028. The proposal would apply to buildings that receive a determination of housing credit dollar amount pursuant to section 42(m)(2)(D) after the date of enactment.

The JCT has estimated that the proposal would lose approximately $4.66 billion over a 10-year period.

KPMG observation

The proposal would be a significant expansion of the LIHTC, increasing the amount of the current credit available to support and expand affordable housing. The proposal also would provide enhanced credits that specifically target and encourage more affordable housing for certain groups or areas such as Indian tribes, extremely low-income households, and rural areas. (See further discussion below in investments in tribal infrastructure discussion.)

The proposal would also make it easier to qualify projects for the 4% credit by reducing the percentage of land and building required for the tax-exempt bond volume cap and also increase the amount of credit for such projects by allowing state housing agencies to designate bond-financed projects as being located in a difficult development area. In addition, the proposal would repeal the qualified contract option thereby preserving the affordability of the low-income project rather than allowing the project to become market rate at the end of the compliance period.

Neighborhood homes investment tax credit

The proposal would provide a new general business credit to (1) taxpayers that develop or rehabilitate property that would be sold to an eligible purchaser who would use the property as the purchaser’s principal residence, or (2) taxpayers that rehabilitate certain owner-occupied property. The proposal would also provide that each State create a new agency (or identify a pre-existing agency) to serve as the Neighborhood Homes Credit Agency (NHCA), with authority to allocate potential Neighborhood Homes Credits (NHCs) to project sponsors. States would receive authority to administer and allocate credits on a competitive basis. NHCs would be allocated to the 50 states, the District of Columbia, and U.S. possessions (State).

Credit for property sold to an eligible purchaser

Specifically, the proposal would provide a tax credit, with respect to a qualified residence sold by a taxpayer in an affordable sale, in an amount which is the lesser of (1) the excess (if any) of (i) reasonable development costs paid or incurred by the taxpayer with respect to the qualified residence, over (ii) the sales price of the qualified residence (reduced by any reasonable expenses paid or incurred by the taxpayer in connection with the sale), or (2) 35% of the lesser of (i) eligible development costs paid or incurred by the taxpayer with respect to the qualified residence or (ii) 80% of the national median sales price for new homes.

The proposal would provide that “reasonable development costs” mean amounts paid or incurred for the acquisition of buildings and land, construction, substantial rehabilitation, demolition of structures, or environmental remediation, to the extent the amounts meet the standards of the NHCA and are necessary to ensure the financial feasibility of the qualified residence.
“Eligible development costs” mean amounts which would be reasonable development costs if the amounts taken into account as paid or incurred for the acquisition of buildings and land did not exceed 75% of the costs determined without regard to any amount paid or incurred for the acquisition of buildings and land.

The proposal would provide that a “qualified residence” must be (1) real property affixed on a permanent foundation; (2) a single-family home (including homes with up to four dwelling units), a condominium, or a residence in a housing cooperative; (3) part of a qualified project which has received an allocation from a NHCA; and (4) located in a qualified census tract (meeting requirements with elevated poverty rates, lower incomes, and modest home values; certain rural areas with lower incomes; or disaster areas). Qualified homeowners would generally include individuals who own and use a qualified residence as their principal residence and whose family income is 140% or less of the median family income for the area.

Rehabilitations of owner-occupied residences

The proposal also would provide a credit to a taxpayer that rehabilitates certain owner-occupied residences. For these rehabilitations, the credit would be allowed in the tax year in which the qualified rehabilitation is completed, and the credit amount would be the lesser of (1) the excess (if any) of (i) amounts paid or incurred by the taxpayer for the qualified rehabilitation of the qualified residence, to the extent the amounts meet the standards of the NHCA, over (ii) any amounts paid to the taxpayer for the rehabilitation; (2) 50% of amounts paid or incurred by the taxpayer for the qualified rehabilitation of the qualified residence, to the extent the amounts meet the standards of the NHCA; or (ii ) $50,000.

The proposal would provide that “qualified rehabilitation” means a rehabilitation performed pursuant to a written binding contract between the taxpayer and the qualified homeowner, if the amount paid or incurred by the taxpayer in the performance of the rehabilitation exceeds $20,000. Qualified homeowners for owner-occupied rehabilitations would generally include individuals who own and use a qualified residence as their principal residence as of the date of the written binding contract and whose family income does not exceed the median family income for the area.

NHCA credit ceiling

The proposal would provide that, for any calendar year, the aggregate amount allocated to qualified projects by the NHCA may not exceed the credit ceiling. Further, the credit allocated to any qualified project may not exceed the amount that the NHCA determines is necessary to ensure the financial feasibility of the qualified project. The credit ceiling for a calendar year for each state for 2022 would be the greater of $8 million or $6 multiplied by the state population, plus certain unallocated credits. This amount would be indexed for inflation for years after 2022.

Responsibilities of NHCCAs

Sponsors seeking potential NHCCs would apply on a competitive basis by providing candidate plans for construction or rehabilitation to the NHCCs. Each NHCA would establish a qualified allocation plan (QAP) to guide it in allocating potential NHCCs among competing proposals. The NHCA would also be responsible for promulgating certain standards, monitoring compliance with all provisions governing NHCCs, and for reporting certain information and noncompliance to the IRS.

The proposal would apply to tax years beginning after December 31, 2021.

The JCT has estimated that the proposal would lose approximately $17.736 billion over a 10-year period.
KPMG observation

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

Bonds

Credit to issuer for certain infrastructure bonds

Current law

In general

Under current law, interest paid on bonds issued by state and local governments generally is excluded from gross income. As an alternative to tax-exempt interest, various tax credit and direct pay bonds have been authorized to lower borrowing costs on certain bonds issued by state and local governments. With direct pay bonds, the issuer of the bond receives a payment from the federal government to offset a portion of the interest expense on the bonds.

State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds the proceeds of which are primarily used to finance governmental functions or which are repaid with governmental funds. Private activity bonds are bonds in which the state or local government serves as a conduit providing financing to nongovernmental persons (e.g., private businesses or individuals). A private activity bond is any bond that satisfies (1) the private business test¹ or (2) the private loan financing test.²

Arbitrage requirements

The exclusion from income for interest on state and local bonds does not apply to any arbitrage bond. An arbitrage bond is defined as any bond that is part of an issue if any proceeds of the issue are reasonably expected to be used (or intentionally are used) to acquire higher yielding investments or to replace funds that are used to acquire higher yielding investments. Subject to limited exceptions, arbitrage profits that are earned during these periods or on such investments must be rebated to the federal government.

The proposal

¹ Under the private business test, a bond is a private activity bond if it is part of an issue in which:
   • More than 10% of the proceeds of the issue are to be used in the trade or business of any person other than a governmental unit ("private business use"); and
   • More than 10% of the payment of principal or interest on the issue is:
     ○ Secured by property used or to be used for a private business use or payments in respect of such property, or
     ○ To be derived from payments in respect of property, or borrowed money, used or to be used for a private business use.

² A bond issue satisfies the private loan financing test if proceeds exceeding the lesser of $5 million or 5% of such proceeds are used directly or indirectly to finance loans to one or more nongovernmental persons.
In general

The proposal would create a new direct pay bond called a “qualified infrastructure bond.” Under the proposal, an issuer could elect to have an otherwise tax-exempt bond treated as a qualified infrastructure bond, subject to satisfaction of additional requirements. A “qualified infrastructure bond” is any obligation (other than a private activity bond) if:

• The interest on such obligation would be (but for the bond being a qualified infrastructure bond) excludable from gross income under section 103,
• The issuer makes an irrevocable election to have the provision apply, and
• Certain additional requirements are satisfied.

In determining if an obligation would be tax-exempt under section 103, the credit allowed to the issuer (discussed below) would not be treated as a federal guarantee. For arbitrage purposes, the yield on a qualified infrastructure bond is reduced by the credit allowed to the issuer (the reduction does not apply in determining the amount of gross proceeds of an issue that qualifies as a reasonably required reserve or replacement fund). A qualified infrastructure bond would not include any bond if the issue price has more than a de minimis amount of premium over the stated principal amount of the bond.

Taxable interest and credit payment to issuer

The interest on a qualified infrastructure bond would be taxable to the bondholder, and the issuer of the bond would be allowed a credit equal to the applicable percentage of each interest payment made under such bond, subject to the limitation on the applicable percentage discussed below. The applicable percentage for a qualified infrastructure bond (other than current refunding bonds, as discussed below) would depend on the calendar year in which the bond is issued as follows:

- 2022 through 2024 ................................................................. 35%
- 2025 .................................................................................... 32%
- 2026 .................................................................................... 30%
- 2027 and thereafter (and current refunding bonds) ............. 28%

For example, if an issuer of a qualified infrastructure bond issued in 2022 pays a $1,000 coupon payment, unless the limitation described in the following paragraph applies, the taxpayer who holds such a bond would include $1,000 of interest in their income and the issuer would receive a payment of 35% of each $1,000 coupon paid to bondholders. (The net interest cost to the issuer would be $650.) The payment by the federal government to the issuer is to be made contemporaneously with the interest payment made by the issuer and may be made either in advance or as reimbursement. In lieu of payment to the issuer, the payment may (at the direction of the issuer) be made to a person making interest payments on behalf of the issuer.

For purposes of calculating the issuer’s allowed credit, the amount of any interest payment taken into account with respect to a bond for any payment date could not exceed the amount of interest which would have been payable under such bond for such payment date if interest were determined at the “applicable credit rate” multiplied by the “applicable amount” for such bond for such payment date.

• The “applicable credit rate” is the rate which the Secretary estimates would permit the issuance of qualified infrastructure bonds with a specified maturity or redemption date without discount and without additional interest cost to the issuer. The applicable credit rate with respect to any qualified infrastructure bond would be determined as of the first day on which there is a binding, written
contract for the sale or exchange of the bond.

- The “applicable amount” for a bond for any payment date would be:
  
  - In the case of any bond that has more than a de minimis amount of original issue discount (determined under the rules of section 1273(a)(3)), the issue price of such bond (within the meaning of section 148), as adjusted for any principal payments made prior to such date, and
  
  - In the case of any other bond, the outstanding principal amount of such bond on such payment date (determined without taking into account any principal payment on such bond on such date).

Regarding sequestration (pursuant to the Balanced Budget and Emergency Deficit Control Act of 1985 or the Statutory Pay-As-You-Go Act of 2010), the proposal would provide that in the case of any payment of the credit to or at the direction of the issuer of a qualified infrastructure bond to which sequestration applies, the amount of such payment is increased to an amount equal to (1) such payment (determined before such sequestration), multiplied by (2) the quotient obtained by dividing 1 by the amount by which 1 exceeds the percentage reduction in such payment pursuant to such sequestration.

**Additional provisions for qualified infrastructure bonds**

To qualify as a “qualified infrastructure bond,” 100% of the excess of available project proceeds of the issue of which the bond is a part over the amounts in a reasonably required reserve (within the meaning of section 150(a)(3)) with respect to such issue would have to be used for:

- Capital expenditures or operations and maintenance expenditures in connection with property the acquisition, construction, or improvement of which would be a capital expenditure, or

- Payments made by a state or political subdivision of a state to a custodian of a rail corridor for purposes of the transfer, lease, sale, or acquisition of an established railroad right-of-way consistent with section 8(d) of the National Trails Act of 1968, but only if the Surface Transportation Board has issued a certificate of interim trail use or notice of interim trail use for purposes of authorizing such transfer, lease, sale, or acquisition.

A bond issued to currently refund a qualified infrastructure bond would not be a qualified infrastructure bond unless:

- The average maturity date (determined in accordance with section 147(b)(2)(A)) of the issue of which the refunding bond is a part is not later than the average maturity date of the bonds to be refunded by such issue,

- The amount of the refunding bond does not exceed the outstanding amount of the refunded bond,

- The refunded bond is redeemed not later than 90 days after the date of the issuance of the refunding bond, and

- The refunded bond was issued more than 30 days after the date of the enactment.

The applicable percentage with respect to any qualified infrastructure bond issued to currently refund another qualified infrastructure bond would be 28%. The proposal also would provide authority for certain advance refunding bonds (when the refunded bond is redeemed more than 90 days after the date of issuance of the refunding bond) to be issued as tax-exempt bonds, subject to applicable requirements. Bonds issued to advance refund qualified infrastructure bonds would not be qualified infrastructure bonds.
The requirements of the Davis-Bacon Act in Subchapter IV of chapter 31 of title 40, United States Code would apply to projects financed with the proceeds of qualified infrastructure bonds.

The JCT estimated that the provision would decrease revenues by approximately $22.5 billion over 10 years.

The proposal would be effective for bonds issued after December 31, 2021.

**KPMG observation**

The proposal would create a new direct pay bond for qualified infrastructure. The proposal does not allow for a tax credit alternative. The proposal does not have an expiration date, however it does scale back the direct pay credit in later years.

**Advance refunding bonds**

Under current law, section 103 generally provides that gross income does not include interest received on state or local bonds. The exclusion from income for interest on state and local bonds applies to refunding bonds subject to certain limits. A refunding bond is defined as any bond used to pay principal, interest, or redemption price on a prior bond issue (the refunded bond).

A bond is classified as an advance refunding bond if it is issued more than 90 days before the redemption of the refunded bond. Prior to the TCJA, the exclusion from gross income for state and local bonds applied, in certain limited circumstances, to advance refundings. The TCJA amended section 149 to repeal the exclusion from gross income for interest on a bond issued to advance refund another tax-exempt bond, effective for refunding bonds issued after December 31, 2017.

The proposal would amend section 149 of the Code to allow the exclusion from gross income for interest on a bond issued to advance refund another tax-exempt bond, subject to limitations similar to those applicable to tax-exempt advance refunding bonds issued prior December 31, 2017.

The JCT estimated that the provision would decrease revenues by approximately $14.9 billion over 10 years.

The proposal would be effective for advance refunding bonds issued more than 30 days after the date of enactment.

**KPMG observation**

This provision would reinstate the rules for advance refunding bonds that were in effect prior to their repeal in the TCJA.
Permanent modification of small issuer exception to tax-exempt interest expense allocation rules for financial institutions

Current law

Present law disallows a deduction for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is exempt from tax. In the case of a financial institution, the Code generally disallows a deduction for that portion of the taxpayer’s interest expense that is allocable to tax-exempt interest. This general rule (in section 265(b) of the Code) does not apply to “qualified tax-exempt obligations.” Instead, as discussed below, only 20% of the interest expense allocable to “qualified tax-exempt obligations” is disallowed.

A “qualified tax-exempt obligation” is a tax-exempt obligation that:

- Is issued after August 7, 1986, by a “qualified small issuer,”
- Is not a private activity bond, and
- Is designated by the issuer as qualifying for the exception from the general rule of section 265(b).

A “qualified small issuer” is an issuer that reasonably anticipates that the amount of tax-exempt obligations that it will issue during the calendar year will be $10 million or less (in certain circumstances, an issuer and all subordinate entities are aggregated).

Section 291(a)(3) reduces by 20% the amount allowable as a deduction with respect to any financial institution preference item. Financial institution preference items include interest on debt to acquire tax-exempt obligations acquired after December 31, 1982, and before August 8, 1986. Section 265(b)(3) treats qualified tax-exempt obligations as if they were acquired on August 7, 1986. As a result, the amount allowable as a deduction by a financial institution with respect to interest incurred to carry a qualified tax-exempt obligation is reduced by 20%.

The American Recovery and Reinvestment Act of 2009 (ARRA) made certain adjustments to section 265 for tax-exempt obligations issued during 2009 and 2010, including increasing from $10 million to $30 million the annual limit for qualified small issuers, treating qualified section 501(c)(3) bonds as if they were issued by the 501(c)(3) organization for whose benefit they were issued (and not by the actual issuer of such bonds), and, for certain qualifying issues, applying the annual volume limitation at the borrower level (rather than at the level of the pooled financing issuer).

The proposal

The proposal would increase from $10 million to $30 million the annual limit for qualified small issuers and would index the annual limit for inflation after 2021.

A “qualified financing issue” is any composite, pooled or other conduit financing issue the proceeds of which are used directly or indirectly to make or finance loans to one or more ultimate borrowers each of whom is a qualified borrower.

For “qualified financing issues,” the proposal would apply the annual volume limitation at the borrower level (rather than at the level of the pooled financing issuer). Thus, for the purpose of applying the requirements of the section 265(b)(3) qualified small issuer exception, the portion of the proceeds of a qualified financing issue that are loaned to a “qualified borrower” that participates in the issue would be treated as a separate issue with respect to which the qualified borrower is deemed to be the issuer.
A “qualified borrower” means (1) a state or political subdivision of a state, or (2) an organization described in section 501(c)(3) and exempt from tax under section 501(a). Thus, for example, a $100 million pooled financing issue could qualify for the section 265(b)(3) exception if the proceeds of such issue were used to make four equal loans of $25 million to four qualified borrowers. However, if:

- More than $30 million (or such increased annual limit as may be applicable under the adjustment for inflation) was loaned to any qualified borrower,
- Any borrower was not a qualified borrower, or
- Any borrower would, if it were the issuer of a separate issue in an amount equal to the amount loaned to such borrower, fail to meet any of the other requirements of section 265(b)(3),

then the entire $100 million pooled financing issue would fail to qualify for the exception.

Additionally, for purposes of determining whether an obligation is a qualified tax-exempt obligation under section 265(b)(3), the proposal would treat qualified section 501(c)(3) bonds as if they were issued by the 501(c)(3) organization for whose benefit they were issued (and not by the actual issuer of such bonds).

The JCT estimated that the provision would decrease revenues by approximately $3.97 billion over 10 years.

The proposal generally would be effective for obligations issued after the date of enactment.

**KPMG observation**

Section 265(b) generally disallows 100% of the interest expense of banks that is allocable to tax-exempt interest. The proposal would increase the size of a tax-exempt bond issuance that would be excluded from this rule and that would instead be taken into account under the 20% disallowance of interest in section 291.

### Modifications to qualified small issue bonds

**Current law**

Qualified private activity bonds are tax-exempt private activity bonds issued to provide financing for specified privately used facilities. Generally, qualified private activity bonds are subject to a number of eligibility restrictions. For example, the aggregate volume of most qualified private activity bonds is restricted by annual state volume limitations (the “state volume cap”). For calendar year 2021, the state volume cap, which is indexed for inflation, equals $110 per resident of the state, or $324,995,000, if greater. Qualified small issue bonds (discussed next) are subject to state volume cap.

Qualified small issue bonds (commonly referred to as “industrial development bonds” or “small issue IDBs”) are tax-exempt qualified private activity bonds issued by state and local governments to finance private business manufacturing facilities or the acquisition of land and equipment by certain farmers.

Qualified small issue bonds are subject to limits on the amount of financing that may be provided. In general, no more than $1 million of small issue bond financing may be outstanding at any time for property of a business (including related parties) located in the same municipality or county. Generally, this $1 million limit may be increased to $10 million if, in addition to outstanding bonds, all other capital expenditures of the business (including related parties) in the same municipality or county are counted toward the limit over a six-year period that begins three years before the issue date of the bonds and
ends three years after such date. Outstanding aggregate borrowing is limited to $40 million per borrower (including related parties) regardless of where the property is located. The Code permits up to $10 million of capital expenditures to be disregarded, in effect increasing from $10 million to $20 million the maximum allowable amount of total capital expenditures by an eligible business in the same municipality or county.

The ARRA made certain temporary adjustments to section 144(a) that expanded the availability of qualified small issue bonds to facilities creating intangible property and modified the related facilities eligible for treatment as part of a manufacturing facility. These changes include expanding the definition of manufacturing facilities to mean any facility that is used in the manufacturing, creation, or production of tangible property or intangible property (within the meaning of section 197(d)(1)(C)(iii)).

**The proposal**

The proposal would increase the limit on qualified small issue bonds that may be outstanding at any time for property of a business (including related parties) located in the same municipality or county from $10 million to $30 million and indexes the limit for inflation after 2021. The issuer could elect to have this limit apply (instead of the generally applicable $1 million limit) if, in addition to outstanding bonds, all other capital expenditures of the business (including related parties) in the same municipality or county are counted toward the limit over a six-year period that begins three years before the issue date of the bonds and ends three years after such date.

Additionally, the proposal would expand the availability of qualified small issue bonds to manufacturing facilities creating intangible property and adds to the related facilities treated as part a manufacturing facility. The definition of manufacturing facility would be expanded to include intangible property (within the meaning of section 197(d)(1)(C)(iii)). For this purpose, intangible property means any patent, copyright, formula, process, design, pattern, knowhow, format, or other similar item. It is intended to include among other items, the creation of computer software, and intellectual property associated biotech and pharmaceuticals. The proposal would add facilities that are functionally related and subordinate to a manufacturing facility as part of the manufacturing facility for purposes of eligible uses of qualified small issue bonds. Functionally related and subordinate facilities must be located on the same site as the manufacturing facility. Directly related and ancillary facilities that are not functionally related and subordinate to a manufacturing facility would be eligible for financing by qualified small issue bonds if (1) such facilities are located on the same site as the manufacturing facility and (2) not more than 25% of the net proceeds of the issue are used to provide such directly related and ancillary facilities.

The proposal includes a limitation that would preclude the issuance of qualified small issue bonds to refund qualified small issue bonds (refunded bonds) issued prior to the date of enactment for manufacturing facilities for intangible property or functionally related and subordinate facilities, unless such refunded bonds financed such facilities pursuant to the temporary rule applicable pursuant to the ARRA, either directly or in a series of refundings.

The JCT estimated that the provision would decrease revenues by approximately $161 million over 10 years.

The proposal generally would be effective for obligations issued after the date of enactment.

**KPMG observation**

The proposal would increase the size of qualified small issue bonds for manufacturing and also expands the scope to include intangible property.
Expansion of certain exceptions to the private activity bond rules for first-time farmers

Current law

Qualified private activity bonds are tax-exempt private activity bonds issued to provide financing for specified privately used facilities. Qualified private activity bonds are subject to a number of eligibility restrictions. For example, the aggregate volume of most qualified private activity bonds is restricted by annual state volume limitations (the "state volume cap"). For calendar year 2021, the state volume cap, which is indexed for inflation, equals $110 per resident of the state, or $324,995,000, if greater. Qualified small issue bonds (discussed next) are subject to state volume cap.

Qualified small issue bonds (commonly referred to as "industrial development bonds" or "small issue IDBs") are tax-exempt qualified private activity bonds issued by state and local governments to finance private business manufacturing facilities (including certain directly related and ancillary facilities) or the acquisition of land and equipment by certain farmers.

In general, qualified private activity bonds, including qualified small issue bonds, may not be issued for the acquisition of land to be used for farming purposes or for the acquisition of used property. Under exceptions to these general rules, qualified small issue bonds can be used for the acquisition of land and used property by first-time farmers for farming purposes, subject to certain limitations. The amount of proceeds that can be used for the acquisition of land by a first-time farmer is limited to a specified amount of $450,000, indexed for inflation for calendar years after 2008. The limit is $558,000 for 2021. Used equipment to be used for farming purposes on any land satisfying the requirements for acquisition by a first-time farmer is also eligible for a qualified small issue bond up to a limit of $62,500. Additionally, there is a $250,000 limit on the amount of net proceeds of a qualified small issue bond used to provide depreciable farm property.

“First-time farmer” means any individual if such individual (including their spouse and minor children) has not at any time had any direct or indirect ownership interest in substantial farmland (any parcel of land unless such parcel is smaller than 30% of the median size of a farm in the county in which such parcel is located) in the operation of which such individual materially participated and has not received financing under the exception permitting the acquisition of land by a first-time farmer in an amount which, when added to the financing to be provided, exceeds the applicable annual limit ($558,000 for calendar year 2021).

The proposal

The proposal would increase the dollar limitations applicable to the use of qualified small issue bonds for the acquisition of land to be used for farming purposes, prior to indexing for inflation, from $450,000 (which was increased after indexing for inflation in calendar year 2021 to $558,000) to $552,500 for bonds issued after the date of enactment and in calendar year 2021, and indexes such limit for inflation after 2021. The proposal would eliminate the lower dollar limitation on used farm equipment, increases the dollar limitation on acquisition of depreciable farm property from $250,000 to $552,500, and indexes such limit for inflation after 2021. Additionally, for purposes of determining if an individual is a first time farmer, the 30% size limit used to determine if a parcel of land is substantial farmland would be based on the average, rather than the median, size of a farm in the county in which such parcel is located.

The JCT estimated that the provision would decrease revenues by approximately $2 million over 10 years.

The proposal would be effective for bonds issued after the date of enactment.
Certain water and sewage facility bonds exempt from volume cap on private activity bonds

Current law

Qualified private activity bonds are tax-exempt private activity bonds issued to provide financing for specified privately used facilities. The definition of a qualified private activity bond includes an exempt facility bond.

Exempt facility bonds are often used to finance infrastructure projects. To qualify as an exempt facility bond, 95% of the net proceeds must be used to finance an eligible facility. Facilities eligible include, among others, facilities for the furnishing of water and sewage facilities that, generally, may be privately owned. A facility for the furnishing of water must meet the following two requirements:

- The water is or will be made available to the public (including electric utility, industrial, agricultural, or commercial users); and
- Either the facility is operated by a governmental unit or the rates for the furnishing or sale of the water have been established or approved by a state or political subdivision thereof, by an agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any state or political subdivision thereof.

Generally, qualified private activity bonds are subject to a number of eligibility restrictions. For example, the aggregate volume of most qualified private activity bonds is restricted by annual state volume limitations (the “state volume cap”). For calendar year 2021, the state volume cap, which is indexed for inflation, equals $110 per resident of the state, or $324,995,000, if greater. Exempt facility bonds issued to provide facilities for the furnishing of water and sewage facilities are subject to the state volume cap requirement.

The proposal

The proposal would provide an exception to the state volume cap requirement for exempt facility bonds issued to provide facilities for the furnishing of water and sewage facilities if 95% or more of the net proceeds of the bonds are used to provide facilities which would be used:

- By a person who was, as of July 1, 2020, engaged in operation of a facility of the type provided, and
- To provide service within the area served by such person on such date (or within a county or city any portion of which is within such area), or by a successor in interest to such person for the same use and within the same service area.

The JCT estimated that the proposal would decrease revenues by approximately $79 million over 10 years.
The proposal would be effective for bonds issued after the date of enactment.

**KPMG observation**

This proposal would exempt certain exempt facility bonds issued after the date of enactment from the state volume cap; however, it would only apply to bonds that finance existing water and sewage facilities in operation as of July 1, 2020.

**Exempt facility bonds for zero-emission vehicle infrastructure**

Under current law, qualified private activity bonds are tax-exempt private activity bonds issued to provide financing for specified privately used facilities. The definition of a qualified private activity bond includes an exempt facility bonds. Exempt facility bonds are often used to finance infrastructure projects. To qualify as an exempt facility bond, 95% of the net proceeds must be used to finance an eligible facility. Eligible facilities include airports, ports (docks and wharves), mass commuting facilities, sewage facilities, qualified residential rental projects, high-speed intercity rail facilities, environmental enhancements of hydro-electric generating facilities, and qualified green building and sustainable design projects.

Generally, qualified private activity bonds are subject to a number of eligibility restrictions. For example, the aggregate volume of most qualified private activity bonds is restricted by annual state volume limitations (the “state volume cap”). For calendar year 2021, the state volume cap, which is indexed for inflation, equals $110 per resident of the state, or $324,995,000, if greater.

The proposal would add a new category of exempt facility bonds for zero-emission vehicle infrastructure. “Zero-emission vehicle infrastructure” means any property (not including a building and its structural components) if such property is part of a unit which

- Is used to charge or fuel zero emissions vehicles,
- Is located where the vehicles are charged or fueled,
- Is of a character subject to the allowance for depreciation (or amortization in lieu of depreciation),
- Is made available for use by members of the general public,
- Accepts payment via a credit card reader (including a credit card reader that uses contactless technology), and
- Is capable of charging or fueling vehicles produced by more than one manufacturer (within the meaning of section 30D(d)(3)).

For property which is part of a unit which is used exclusively by fleets of commercial or governmental vehicles, the last three requirements listed would not apply. “Zero-emission vehicle infrastructure” also would include any utility service connections, utility panel upgrades, line extensions and conduit, transformer upgrades, or similar property, in connection with property meeting the applicable requirements.

The term “zero-emissions vehicle” means either a zero-emission vehicle as defined in section 88.102–94 of title 40, Code of Federal Regulations, or a vehicle that produces zero exhaust emissions of any criteria pollutant (or precursor pollutant) or greenhouse gas under any possible operational modes and conditions.

Any zero-emission vehicle infrastructure located within another type of facility or project eligible for...
financing by exempt facility bonds, or an area adjacent to such a facility or project that primarily serves vehicles traveling to or from such facility or project, would be treated as that type of facility or project for purposes of eligibility restrictions applicable to exempt facility bonds.

Except to the extent not applicable due to the treatment described in the preceding paragraph, the state volume cap would apply to exempt facility bonds issued for zero-emission vehicle infrastructure.

The JCT estimated that the proposal would decrease revenues by approximately $116 million over 10 years.

The proposal would be effective for obligations issued after December 31, 2021.

**KPMG observation**

The proposal would add zero-emission vehicle infrastructure as an additional facility eligible to be funded through private activity bonds; however, it does not include an overall increase in the volume cap for private activity bonds.

Unlike the other proposals expanding the scope of tax-exempt bonds, this proposal would be effective for obligations issued after December 31, 2021.

**Application of Davis-Bacon Act requirements with respect to certain exempt facility bonds**

Under current law, qualified private activity bonds are tax-exempt private activity bonds issued to provide financing for specified privately used facilities. The definition of a qualified private activity bond includes an exempt facility bond. Exempt facility bonds are often used to finance infrastructure projects. To qualify as an exempt facility bond, 95% of the net proceeds must be used to finance an eligible facility. Eligible facilities include airports, ports (docks and wharves), mass commuting facilities, sewage facilities, qualified residential rental projects, high-speed intercity rail facilities, environmental enhancements of hydro-electric generating facilities, and qualified green building and sustainable design projects.

Generally, qualified private activity bonds are subject to a number of eligibility restrictions that do not apply to governmental bonds. For example, the aggregate volume of most qualified private activity bonds is restricted by annual state volume limitations (the “state volume cap”). For calendar year 2021, the state volume cap, which is indexed for inflation, equals $110 per resident of the state, or $324,995,000, if greater.

The proposal would add a new requirement for exempt facility bonds issued to provide facilities for the furnishing of water, sewage facilities, and qualified highway or surface freight transfer facilities, and for such bonds issued to provide zero-emission vehicle infrastructure under section 135107 of this proposal. These facilities would only be eligible for financing with exempt facility bonds if each entity that receives bond proceeds to conduct construction, alteration, or repair of such facilities agrees to comply with the provisions of subchapter IV of chapter 31 of title 40, United States Code (the “Davis-Bacon Act”) with respect to such construction, alteration, or repair. The Davis-Bacon Act generally provides that contractors and subcontractors on certain federally funded or assisted contracts must pay their laborers and mechanics employed under the contract no less than the locally prevailing wages and fringe benefits for corresponding work on similar projects in the area.

The JCT estimated that the provision would no effect on revenues over a 10-year period.
The proposal would be effective for bonds issued after the date of enactment.

**KPMG observation**

David-Bacon labor standards already applied to section 54A tax credit bonds.

**Tax-exempt bond financing requirement**

**Current law**

**In general**

A taxpayer may claim the low-income housing tax credit annually over a 10-year period for the costs of building or rehabilitating rental housing occupied by low-income tenants. The amount of credit that may be claimed each year is an amount equal to the applicable percentage of the qualified basis of each qualified low-income building.

**Credit calculations**

The applicable percentage for non-federally subsidized newly constructed housing and non-federally subsidized substantial rehabilitation is calculated such that the present value of the credit amounts is at least 70% of a building’s qualified basis (“nine-percent credits”). The applicable percentage for federally subsidized newly constructed housing, federally subsidized substantial rehabilitation, and certain housing acquisition costs, is calculated such that the present value of the credit amounts is at least 30% of a building’s qualified basis (“four-percent credits”). The applicable percentage is fixed at no less than 9% for non-federally subsidized new buildings placed in service after July 30, 2008. For bond financed projects for bonds issued after 12/31/2020 or acquisitions of existing properties that receive allocations and are placed in service after 12/31/2020, the applicable percentage is fixed at no less than 4%.

**Credit allocations**

A low-income housing tax credit is generally allowable only if the building owner receives a housing credit allocation from a state or local housing credit agency. The amount of housing credit allocated by a state to a low-income building reduces the state housing credit ceiling only once, in the year the housing credit is allocated.

**Special rule for buildings financed by tax-exempt bonds**

If 50% or more of the aggregate basis of the building and the land on which the building is located is financed by the proceeds of tax-exempt bonds, a low-income housing tax credit is allowable with respect to the entire eligible basis of the project without an allocation from the state or local housing credit agency and at no charge to the states’ housing tax credit cap. If less than 50% of the aggregate basis is so financed, this exception only applies to the low-income housing tax credit with respect to the portion financed by the proceeds of tax-exempt bonds. The tax-exempt bonds must be subject to the volume cap for private activity bonds and, once bond proceeds are used to finance a project, principal payments on such financing must be applied within a reasonable period to redeem the bonds.
The proposal

The proposal would modify the special rule that allows a low-income housing tax credit on the entire eligible basis of a building without an allocation from the state or local housing credit agency and at no charge to the states’ housing tax credit cap as long as 50% or more of the aggregate basis is financed with certain tax-exempt bonds. The percent limitation would be lowered from 50% to 25% for buildings that are financed by the proceeds of certain tax-exempt bonds issued in calendar year 2022, 2023, 2024, 2025, 2026, 2027, or 2028 (and not by any obligation taken into account during any tax year beginning during calendar year 2019, 2020, or 2021). See previous discussion of [low-income housing tax credit proposals](#).

The JCT estimated that the provision would decrease revenues by approximately $9.5 billion over 10 years.

The proposal would apply to buildings placed in service in tax years beginning after December 31, 2021.

**KPMG observation**

The proposal would reduce the amount of tax-exempt financing required to exclude a project from the state allocation and tax credit cap. Eligible tax-exempt financing is subject to the volume caps on private activity bonds. By lowering the percentage of financing required from tax-exempt bonds, the proposal would allow developers to undertake projects with less tax-exempt financing, potentially allowing for more projects to qualify for the low-income housing tax credit.

Investments in tribal infrastructure

**Treatment of Indian tribes as states with respect to bond issuance**

**Current law**

*Treatment of Indian tribal governments as states for certain purposes*

Section 7871 expressly provides that Indian tribal governments are treated as states for certain tax purposes. Special treatment relating to excise taxes is available to tribal governments only for transactions involving the exercise of an essential governmental function by the Indian tribal government. Indian tribal governments are also treated as states in that they may issue tax-exempt bonds, subject to certain conditions described further below.

*Tax-exempt bonds*

Under present law, gross income does not include interest on state or local bonds. State and local bonds are classified generally as either governmental bonds or private activity bonds. Private activity bonds are bonds in which the state or local government serves as a conduit providing financing to nongovernmental persons. For these purposes, the term “nongovernmental person” includes the Federal government and all other individuals and entities other than states or local governments.

States may issue tax-exempt private activity bonds subject to a per-state volume cap. For calendar year 2021, the state volume cap, which is indexed for inflation, equals $110 per resident of the state, or $324,995,000, if greater.
Issuance of tax-exempt bonds by Indian tribal governments

Indian tribal governments may issue tax-exempt bonds in several circumstances if they meet requirements applicable to bonds issued by states and local governments as well as certain other rules applicable only to Indian tribal governments. Indian tribal governments may issue tax-exempt bonds for governmental purposes, subject to the requirement that substantially all of the proceeds of the issue are used in an essential governmental function. Indian tribal governments also may issue private activity bonds but only for the purpose of financing manufacturing facilities.

Indian tribal governments may also issue a third type of tax-exempt bond called “tribal economic development bonds” to finance projects and facilities (but not certain gambling facilities) if the bonds would be tax-exempt if issued by a state or local government. The restriction of essential government function and the limitation on private activity bonds to certain manufacturing facilities do not apply. This Code provision is subject to an allocation limit of $2 billion.

Governmental bonds

Like states and local governments, Indian tribal governments may issue so-called “governmental bonds.” Indian tribal governments must meet an additional requirement to issue governmental bonds. Specifically, all bond proceeds must be used in an essential governmental function, and such function must be customarily performed by state and local governments with general taxing powers.

Private activity bonds for tribal manufacturing facilities

As with governmental bonds, Indian tribal governments are more restricted than states and local governments in their ability to issue private activity bonds. Section 7871(c)(3) permits tribal governments to issue private activity bonds so long as the bond proceeds are used for manufacturing facilities that are owned and operated by the tribal government on “qualified Indian lands,” and that employ tribal members. A project financed by manufacturing facility bonds must meet requirements as to use, location and ownership, and employment.

Tribal economic development bonds

Indian tribal governments are also permitted to issue “tribal economic development bonds.” A tribal economic development bond is any bond issued by an Indian tribal government (1) the interest on which would be tax-exempt if issued by a state or local government, and (2) that is designated by the Indian tribal government as a tribal economic development bond.

The aggregate face amount of bonds that may be designated by any Indian tribal government cannot exceed the amount of national tribal economic development bond limitation allocated to such government. There is a national bond limitation of $2 billion, allocated as the Secretary determines appropriate, in consultation with the Secretary of the Interior.

Under the tribal economic development bond program, Indian tribal governments have the authority to issue bonds to finance projects and facilities owned by Indian tribes and located on Indian reservations, but outside the scope of “essential governmental function” bonds, such as convention centers, golf courses, hotels, restaurants, certain entertainment facilities, etc. In addition, Indian tribal governments have the authority to issue private activity bonds for any one of the seven types of “qualified bonds” used for purposes that Congress has permitted and are not limited to financing tribal manufacturing facilities.
Tribal economic development bonds cannot be used to finance any portion of a building in which class II or class III gaming (as defined in section 4 of the Indian Gaming Regulatory Act) is conducted, or housed, or any other property used in the conduct of such gaming. Nor can tribal economic development bonds be used to finance any facility located outside of the Indian reservation.

The proposal

The proposal would allow Indian tribal governments to issue governmental bonds and private activity bonds on a basis similar to state and local governments, but with certain location and gambling facility restrictions applicable to private activity bonds.

First, under the proposal, the essential governmental function standard would not apply to the issuance of tax-exempt bonds by Indian tribal governments.

Second, for private activity bonds, the proposal would require the Treasury Secretary annually to establish a national Tribal private activity bond volume cap for all Indian tribes based on the greater of:

- The state population formula approach in section 146(d)(1)(A) (using national tribal population estimates supplied annually by the Department of the Interior in consultation with the Census Bureau), and
- The minimum state ceiling amount in section 146(d)(1)(B) (as adjusted for the cost of living).

The Treasury Secretary also would be required annually to allocate the national bond volume cap among Indian tribal governments seeking an allocation in a particular year under regulations prescribed by the Secretary. The present-law limits on using state volume cap to finance a facility located outside of the state (section 146(k)(1)) would not apply to volume cap allocated under the proposal to the extent that such cap is used with respect to financing for a facility located on qualified Indian lands.

No portion of volume cap allocated to an Indian tribal government under the proposal could be used with respect to the financing of any portion of a building in which class II or class III gaming (as defined in section 4 of the Indian Gaming Regulatory Act) is conducted or housed or any property actually used in the conduct of such gaming.

There would be no volume cap for governmental bonds issued by an Indian tribal government.

The proposal would include a special rule for situations when an Indian tribal government has authorized an intertribal consortium, a Tribal organization, or an Alaska Native regional or village corporation to plan for, coordinate, or otherwise administer services, finances, functions, or activities on its behalf. In such cases, the authorized entity would have the rights and responsibilities of the authorizing Indian tribal government only to the extent provided in the authorizing resolution.

The JCT estimated that the provision would decrease revenues by approximately $77 million over 10 years.

The proposal would be effective for obligations issued in calendar years beginning after the date of enactment.

KPMG observation

This proposal generally would expand the ability of Indian Tribal Governments to issue tax-exempt
bonds. Current law generally limits Indian Tribal Governments to using tax-exempt bonds for essential government functions and private activity bonds for manufacturing facilities. Section 7871(f) limited the Tribal Economic Development Bonds, which provide greater flexibility for Indian Tribal Governments, to a one-time limitation of $2 billion, of which only $58.7 million of limitation remains. The proposal would generally put Indian Tribal Governments on a similar treatment as state and local governments by eliminating the “essential government function” restriction for government bonds and allowing Indian Tribal Governments generally to issue all types of private activity bonds, subject to an annual national volume limitation and a restriction on using the proceeds to finance certain gaming facilities.

**NMTC for tribal statistical areas**

A proposal relating to the NMTC and tribal statistical areas is referenced in the NMTC discussion above.

**Inclusion of Indian areas as difficult development areas**

The proposal would modify the definition of a difficult development area to automatically include projects located in an Indian area, making these projects eligible for up to a 130% increase in eligible basis. The difficult development area inclusion is limited to buildings that were assisted or financed under the Native American Housing Assistance and Self Determination Act of 1996, or, the project sponsor is a qualifying Indian tribe. The proposal would apply to buildings placed in service after December 31, 2021.

The JCT has estimated that the proposal would lose approximately $114 million over a 10-year period.

**KPMG observation**

The proposal would provide enhanced credits that specifically target and encourage more affordable housing for Indian tribes, provided the building is financed under the Native American Housing Assistance and Self Determination Act of 1996, sponsored by an Indian tribe or a tribally designated housing entity, or wholly owned or controlled by an Indian tribe or a tribally designated housing entity.

**Investments in the territories**

**Possessions economic activity credit**

This proposal would create a new economic activity credit related to active businesses conducted in U.S. territories or possessions. The new credit would be a general business credit equal to 20% of the sum of the qualified possession wages and allocable employee fringe benefit expenses paid or incurred by a qualified domestic corporation for the tax year up to $50,000 with respect to each full-time employee.

A qualified domestic corporation encompasses both U.S. corporations and a U.S. shareholder of a foreign qualified corporation that is wholly owned by the same US group if they meet both source of income and active conduct of trade or business tests.

For purposes of the credit, “possessions” would include the five fiscally autonomous territories of American Samoa, Guam, Commonwealth of Northern Marianas, Commonwealth of Puerto Rico, and the U.S. Virgin Islands.
This proposal would apply to tax years beginning after the date of the enactment of this Act, and in the case of a qualified corporation that is a foreign corporation, to tax years beginning after the date of enactment and to tax years of United States shareholders in which or with which such tax years of foreign corporations end.

The JCT has estimated that the proposal would lose approximately $10.6 billion over a 10-year period.

**Additional NMTC allocations for the territories**

Refer to the NMTC discussion above.

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**Green energy**

**Renewable electricity and reducing carbon emissions**

**Extension of credit for electricity produced from certain renewable resources and extension and modification of the energy tax credit**

**Wind energy**

Under current law, a taxpayer must 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. Further, a taxpayer that begins construction of a solar energy facility in 2023 is eligible for a 22% ITC. Projects that begin construction after 2023 are eligible for a 10% ITC. Finally, any project placed in service after 2025, no matter when construction began, is eligible for a 10% ITC.

**Other renewables**

The PTC is available for geothermal, biomass, trash combustion, landfill gas, hydropower and wave, and 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 begin 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.

**Proposed PTC modifications**

In the proposal, the PTC would be extended and modified in various ways. The proposal would include a base credit rate of 0.5 cents/kilowatt hour, and alternatively, a bonus credit rate of 2.5 cents per kilowatt/hour.

In order to claim the PTC at the bonus credit rate the taxpayer would have to satisfy:

1) A prevailing wage requirement for the full construction period and for the duration of the 10-year PTC credit period, and
2) Apprenticeship requirements during the construction of the project.

For purposes of the PTC, and for other energy credit provisions in the proposal, the prevailing wage requirement means that taxpayers must ensure that any laborers and mechanics employed by contractors and subcontractors are paid prevailing wages during construction and, in some cases, for the alteration and repair of such project for a period of time after the project is placed into service. If a taxpayer fails to satisfy these requirements, the taxpayer may cure the failure by compensating each worker the difference between wages paid and the prevailing wage, plus interest, in addition to paying a $5,000 penalty to the Treasury for each worker paid below the prevailing wage during the tax year.

Again, for purposes of the PTC and other energy credit provisions in the proposal, the apprenticeship requirement requires taxpayers to ensure that no fewer than the applicable percentage of total labor hours are performed by qualified apprentices. The applicable percentage for purposes of this requirement would be 5% for projects for which construction begins in 2022. This rate would be increased to 10% in 2023, and 15% thereafter. In the event a taxpayer fails to satisfy these requirements, the taxpayer may cure the failure by paying a $500 penalty for each labor hour for which the requirement is not satisfied. There is also an exemption process in the event there is a lack of available qualified apprentices.

Projects that commenced construction before the date of enactment or that have a maximum net output of less than one megawatt would be treated as eligible for the bonus rate.

The proposal also makes solar energy facilities eligible for the PTC.

The proposal would make the 100% of the (base and bonus) PTC credit rate available for facilities that commence construction by the end of 2031, 80% available for facilities that commence construction by the end of 2032, and 60% for facilities that commence construction in 2033, and no credit for facilities that commence construction in 2034 and later.

The proposal would allow taxpayers to claim an increased credit for facilities placed into service after December 31, 2021 if the facilities meet certain domestic content requirements. The proposal would provide a base credit increase of 2% of the amount otherwise allowable, or a bonus credit increase of 10% of the amount otherwise allowable with respect to such facility. These values are not subject to phasedown in 2032 and 2033.
For purposes of the PTC, and for other energy credit provisions in the proposal, the domestic content rule requires taxpayers to ensure that facilities are composed of steel, iron, or products manufactured in the United States. For purposes of these requirements, a manufactured product is deemed to have been manufactured in the United States if not less than 55% of the total cost of the components of such product is attributable to components that are mined, produced, or manufactured in the United States. Such rules are to be applied in a manner consistent with the United States' obligations under international rules.

**Proposed ITC modifications**

The proposal would extend the ITC, which allows taxpayers to claim a tax credit for the cost of qualified energy property. In most cases, the provision would extend the credit for property for which construction begins by the end of 2032, and then would phase down the credit value over two years.

The proposal would provide a base credit rate of 6% of the basis of qualified energy property or a bonus credit rate of 30% of the basis of qualified energy property. These credit rates would apply with respect to facilities placed into service after December 31, 2021. The base credit rate would phase down to 5.2% for facilities that commence construction in 2032 and 4.4% for facilities that commence construction in 2033. The bonus credit rate would phase down to 26% in 2032 and 22% in 2033. And then for 2034 and thereafter, for solar and geothermal property, the base rate would be 2% and the bonus rate would be 10%. For other ITC eligible property, no credit would be allowed for projects that begin construction after 2033 or not placed in service before 2036.

In order to claim the ITC at the bonus credit rate, the taxpayer would have to satisfy:

1) A prevailing wage requirement for the full construction period and during the five-year recapture period after the project is placed in service
2) Apprenticeship requirements during the construction of the project

For the ITC, the proposal states that, once an ITC eligible project has been placed in service, if it does not meet prevailing wage requirements associated with any alterations or repairs during the five-year period beginning after it has been placed in service, the enhanced credits shall be recaptured under rules similar to section 50(a)(1). A taxpayer may bring the facility into compliance by paying any affected workers the difference between the actual compensation paid to such workers and the wages required to be paid to those workers to meet prevailing wage requirements, plus any applicable interest. In addition, such taxpayer must also pay a penalty to the IRS equal to $5,000 per affected worker.

Projects that commence construction before date of enactment or have a maximum net output of less than one megawatt would be treated as eligible for the bonus rate (i.e. exempt from prevailing wage and apprenticeship requirements).

The proposal would add the domestic content requirement to the ITC. If the project meets the requirements, the proposal would provide a base credit increase of 2% of the amount otherwise allowable, or a bonus credit increase of 10% of the amount otherwise allowable with respect to such facility.

Finally, the ITC would be expanded in the proposal to include new technologies eligible for a 6% base credit rate or a 30% bonus rate through the end of 2031, phasing down in 2032 and 2033. These technologies are also eligible for increased credits if the domestic content requirements are met. These new ITC technologies include energy storage technology, linear generators, microgrid controllers, dynamic glass, and biogas property.
The proposal would apply to facilities placed into service after December 31, 2021. The amendments pertaining to newly eligible property apply to period after December 31, 2021 under rules similar to former section 48(m).

The JCT has estimated that the above proposals would lose approximately $106.8 billion over a 10-year period.

KPMG observation

The proposal would make significant changes to the ITC and PTC. Most significantly, linking eligibility for full credit rates to requirements for prevailing wages and apprenticeships and the additional increase for domestic content is completely new. These requirements would likely affect the economics of developing these projects, either because accessing the higher credit rates would likely result in projects that are also more expensive to build, or because the credits could end up significantly less in the event the new requirements are not met. For the ITC, it would be interesting to see how meeting labor and domestic content requirements could, depending on the cost, increase ITC eligible basis. Furthermore, the need to substantiate and adequately monitor compliance with these standards would be new and potentially difficult for both taxpayers and the IRS. These requirements will be closely watched as this legislative process advances. It further remains to be seen if these requirements would be permissible under the Senate procedures governing budget reconciliation bills.

The proposal would make other interesting changes to the ITC and PTC. In particular, reviving PTC eligibility for solar would provide added flexibility for those projects, though note that the PTC requirement that electricity is ultimately sold to third parties would apply to solar. Additionally, because the PTC is not subject to normalization rules, this may be a welcome change for regulated utilities developing solar projects. The normalization rules 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. On the other hand, while the addition of new technologies to the ITC, especially energy storage, would be a long awaited change, many regulated utilities would likely also benefit from flexibility around normalization for energy storage but such flexibility was not included in the proposal.

Finally, the effective dates of the changes in the proposal should be considered carefully. For the most part the changes would be effective for projects that are placed in service after December 31, 2021. For the newly eligible ITC technologies (e.g. storage), the effective date invokes a transition rule under former section 48(m) which generally operates so that the credit provisions apply only to the portion of the eligible basis that is constructed after the effective date. The proposal also helpfully provides that projects that are under construction before the date of enactment would be eligible for the bonus rate, regardless of whether the bonus rate requirements are met.

Increase in energy credit for solar facilities placed in service in connection with low-income communities

The proposal would add a provision for an enhanced ITC for solar projects that receive an allocation of environmental justice solar capacity limitation from the Secretary. The allocation criteria the Secretary
would consider include:

- The greatest health and economic benefits (including ability to withstand extreme weather events) for individuals in low-income communities;
- The greatest employment and wages for such individuals; and
- The greatest engagement with outreach to, or ownership by, such individuals, including through partnerships with local governments and community-based organizations.

The annual capacity limitation is 1.8 gigawatts for each calendar year 2022 through 2031 and zero for calendar years thereafter. The annual capacity limitation would be increased by the amount of any unused allocations from the preceding calendar year, but not beyond 2033. Such projects receiving an allocation of environmental justice solar capacity limitation would receive an additional 10% credit if located in a low-income community (as defined within the New Markets Tax Credit program under section 45D) or an additional 20% credit if such project is a qualifying low-income residential building project or a low-income economic benefit project. This section would apply to periods after December 31, 2021 under rules similar to section 48(m) (as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1990).

The JCT estimate for this provision is included in the score in the previous proposal.

**KPMG observation**

This enhanced amount would be another entirely new component of the ITC. Adding an additional 10% or 20% credit to the ITC, depending on the application of labor and domestic content credit amounts, could potentially result in credits rates for these projects at 50% and would certainly offer an attractive incentive to develop solar in low-income communities.

**Elective payment for energy property and electricity produced from certain renewable resources, etc.**

The proposal would add a new section allowing taxpayers to elect to be treated as having made a payment of tax equal to the value of credit they otherwise would have claimed under the following provisions:

- Section 48 ITC
- Section 45 PTC
- Section 45Q credit for carbon capture and sequestration
- Section 30C credit for alternative fuel vehicle refueling property credit
- Section 48C advanced energy project credit
- Section 48D investment credit for transmission property
- Section 48E zero emissions facility credit
- Section 45W zero-emission nuclear production tax credit
- Section 45X clean hydrogen production credit

For the credits under sections 48, 45, and 48D the proposal would impose a phasedown of 100% direct pay contingent meeting domestic content requirement. Specifically, for facilities that do not meet the domestic content requirements, the election for direct payment would be limited to 90% of the otherwise allowable credit value for projects that commence construction in 2024, 85% for projects that
Taxpayers making a direct payment election under this rule would forfeit 100% of their otherwise allowable tax credits, notwithstanding the reduction in the direct payment. In other words, no credit is available for the portion of the reduced direct payment.

The proposal states that the Secretary shall provide exceptions in some circumstances. Specifically, if the Secretary, in consultation with the Secretary of Commerce, determines that such materials and products are not produced in the United States in sufficient quantity and quality or inclusion of domestic material would increase the cost of such facility by more than 25%, the applicable percentage with respect to such facility would be 100%.

The proposal states that, for purposes of the election, tax-exempt entities, including State and local governments and Indian tribal governments, are treated as taxpayers eligible to elect a direct payment. In the case of a partnership or S corporation, elections and direct payments are made at the partnership or S corporation level. The proposal would make some special rules applicable to tax-exempt and government entities, partnerships, and S corporations. For instance, the proposal states that direct payment amounts shall be treated as tax-exempt income for purposes of sections 705 and 1366 and that a partner’s distributive share of such tax-exempt income shall be based on the partner’s distributive share of the otherwise applicable credit for each tax year. The proposal directs the Secretary to issue regulations or other guidance providing rules for determining the partner’s distributive share of the tax-exempt income.

The proposal also provides that taxpayers may be required to provide information or submit to a registration as required by the Secretary.

This provision would apply to projects placed into service after December 31, 2021. Projects could make elections under this section starting 180 days after date of enactment.

The JCT estimate for this provision is included in the score in the previous section.

KPMG observation

The idea of refundable energy tax credits through a direct pay mechanism has been included in various proposals over the last few years. In many cases, developers do not have sufficient tax liability to use the available credits and must rely on tax equity investors to assist in financing projects. Accordingly, a direct pay mechanism has been viewed as a way to remove barriers and more efficiently incentivize the development of a greater number of projects.

The proposal adds potentially new layers (and new complications) to this idea by linking direct pay for many of the credits to meeting the domestic content requirements. This is on top of direct pay amounts that may already be significantly limited if the prevailing wage and apprenticeship requirements are not satisfied. However, it is important to note that the proposal provides that the direct pay phase down for failure to meet domestic content requirements would not apply to projects on which construction begins prior to 2024, so there would be some lead time to transition to these requirements.

Additionally, while the text includes some helpful specifics about how a direct pay program would operate, there are still some open questions. For instance, the text appears to leave most of the procedural aspects of the program, e.g., how much front-end vetting would be required and how much time it would take for refunds to be reviewed and paid, to be handled in regulations. The proposal does not specify whether or not regulated utilities would have to normalize the refund.
Regulations would also be necessary to speak to certain issues related to the treatment of a direct payment by tax-exempt entities and partnerships. And specific to partners in partnerships, it is not clear in the proposal how the passive activity and at-risk rules, which currently limit the benefit of tax credits to individual investors, would apply.

**Investment credit for electric transmission property**

The proposal includes an investment tax credit equal to a percentage of the taxpayer’s basis in qualifying electric transmission property under section 48D. The credit would be available with a base credit rate of 6% of the basis of qualified electric transmission property or a bonus credit rate 30% of the basis of qualified electric transmission property. In order to claim the ITC at the bonus credit rate, taxpayers would have to satisfy:

1) Prevailing wage requirements for the duration of the construction of the project and for five years after the project is placed into service, and
2) Apprenticeship requirements during the construction of the project.

Qualifying electric transmission property is defined as tangible, depreciable property that is:

- An electric transmission line that is capable of transmitting electricity at a voltage of not less than 275 kilowatts and has a transmission capacity of not less than 500 megawatts; or
- A related transmission property, with respect to any electric transmission line, that is any property listed as a ‘transmission plant’ in the Uniform System of Accounts for the Federal Energy Regulatory Commission (FERC), and that is necessary for the operation of such electric transmission line. No credit is allowable with respect to related transmission property unless the taxpayer is also allowed a credit for the qualifying electric transmission property to which it relates.

The proposal would add the domestic content requirement to this transmission ITC. If the project meets the requirements, the proposal would provide a base credit increase of 2% of the amount otherwise allowable, or a bonus credit increase of 10% of the amount otherwise allowable with respect to such facility.

Under the proposal, the transmission ITC would be refundable under a direct pay election. This credit is one of the credits that would be subject to a phase down if domestic content requirements are not satisfied. Specifically, for projects that do not meet the domestic content requirements, the election for direct payment would be limited to 90% of the otherwise allowable credit value in 2024, 85% in 2025, and 0% in 2026 and later.

No credit would be allowed for with respect to (1) any property if the Federal Energy Regulatory Commission or any regional transmission organization has, before January 1, 2022, selected for cost allocation such property for cost recovery, or (2) any property if the construction of such property begins before January 1, 2022, or construction of any portion of the qualifying electric transmission line to which such property relates begins before such date.

The proposed credit would be effective for property placed in service after December 31, 2021.

The JCT has estimated that the proposal would lose approximately $9.8 billion over a 10-year period.
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. This proposal does not allow regulated utilities to opt out of normalization. As noted previously, because the ITC is subject to the normalization rules, regulated utilities may not be as incentivized as nonregulated entities to make these investments. Additionally, if there is an election to make the credit refundable, it is not clear whether the refund would be subject to normalization rules.

The specific prohibition on eligibility for the transmission ITC for projects already under construction but not yet placed in service is notable. The reasoning for that limiting language is unclear but it is likely an effort to limit the incentive to purely newly investment, rather than subsidizing projects that have been under development for several years and for which significant investments have already been made.

Zero emissions facility credit

The proposal would add what would be a new section 48E providing for a new 30% capped credit for qualified property that is part of a zero emissions facility.

A zero emissions facility is a facility which:

1) Generates electricity;
2) Does not generate any greenhouse gases;
3) Uses a technology or process which, in the calendar year in which an amount of credit is designated with respect to such facility, achieved a market penetration level of less than 3% for the commercial generation of electricity; and
4) Does not otherwise meet the definitions for eligible property under the renewable energy production credit, the advanced nuclear power credit, the carbon oxide sequestration credit, or the energy investment tax credit.

Eligible property is tangible, depreciable property, not including a building or its structural components, that is necessary for the generation of electricity.

Taxpayers would not be automatically eligible for the section 48E credit. Rather, credits would be allocated by the Secretary, in consultation with DOE and EPA, through an application process. The Secretary would be authorized to allocate up to $250 MM in credits per calendar year beginning with calendar year 2022 and ending with calendar year 2031. To be credit eligible, qualified property must be placed in service within four years from the date of the credit allocation.

In determining which zero emissions facilities to certify under section 48E, the Secretary is supposed to take into consideration which facilities:

1) Would result in the greatest reduction of greenhouse gas emissions;
2) Have the greatest potential for technological innovation and commercial deployment; and
3) Would result in the greatest reduction of local environmental effects that are harmful to human health.

Taxpayers applying for an allocation of credit are required to provide written assurances to the Secretary
that all laborers and mechanics employed by contractors and subcontractors are paid prevailing wages and that the apprenticeship requirements are satisfied.

Taxpayers may elect to receive a direct payment in lieu of this credit under rules similar to those described above providing for an elective payment for energy property and electricity from certain renewable resources.

The proposal would be effective for periods after December 31, 2021, under rules similar to former section 48(m).

The JCT has estimated that the proposal would have a negligible effect on revenue over a 10-year period.

**Extension of credit for carbon oxide sequestration**

The proposal would extend and modify the credit for carbon oxide sequestration facilities.

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 enhanced oil recovery (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 proposal would extend the section 45Q credit for projects that commence construction before the end of 2031.

The proposal also would modify the minimum capture thresholds. To qualify for the credit, direct air capture facilities must capture no less than 1,000 metric tons of carbon oxide per year. Electricity generating facilities must capture no less than 18,750 metric tons of carbon oxide and 75% of total carbon emissions. Other industrial facilities must capture no less than 12,500 metric tons of carbon oxide and 50% of total carbon emissions.

The proposal provides a base credit rate of $10 and a bonus credit rate of $50 per metric ton of carbon oxide captured for geological storage and a base credit rate of $7 and a bonus credit rate of $35 per metric ton of carbon oxide captured and used as tertiary injectant in an EOR project or utilized in a
commercial product or process. The proposal would provide an enhanced credit for direct air capture facilities at a base rate of $36 and a bonus rate of $180 per metric ton of carbon oxide captured for geological storage and base rate of $26 and a bonus rate of $130 per metric ton of carbon captured and utilized for an allowable use by the taxpayer.

In order to claim the section 45Q credit at the bonus credit rate, taxpayers would have to satisfy the:

1) Prevailing wage requirements for the duration of the construction of the project and for the 12-year credit period, and
2) Apprenticeship requirements during the construction of the project.

Projects that commenced construction before the date of enactment would be treated as eligible for the bonus rate.

Under the proposal, the section 45Q credit would be refundable under a direct pay election.

The extension would be effective for facilities the construction of which begins after December 31, 2025. The other changes would be effective for tax years beginning after December 31, 2021.

The JCT has estimated that the proposal would lose approximately $908 million over a 10-year period.

**KPMG observation**

Carbon capture projects continue to generate significant interest from developers and investors. The economics of these projects in most cases rely on the availability of a subsidy because for many of these projects there is no revenue stream associated with the capture activity. It unknown how a potential decrease in subsidy level under the proposed prevailing wage and apprenticeship requirements may affect project economics. Similar to the PTC and ITC, the proposal would provide a transition rule for section 45Q projects currently under construction by making those projects eligible for the bonus credit rate, without regard to labor requirements.

Also note that the proposal does not include the availability of an increased credit for domestic content, though, relatedly, section 45Q projects would not be subject to the phase down of the direct payment amount associated with the domestic content requirement.

If projects are able to satisfy the prevailing and wage and apprenticeship requirements, the availability of direct pay would be a positive development. 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 proceeding carefully for a variety of reasons including novel technology, offtake and storage uncertainty, and commodity price risk. A direct pay section 45Q tax credit could make these projects significantly less complicated to finance.

Finally, the proposed modifications to the minimum capture thresholds would be a welcome change for many taxpayers. The current law minimum capture thresholds have proven difficult to satisfy for some projects.

**Green energy publicly traded partnerships**

The proposal would expand the rules governing publicly traded partnerships to include a much broader list of qualified income items that would effectively allow for renewable energy projects to be treated as
good assets for testing a publicly traded partnership under section 7704.

The list of new qualified income items would be as follows:

1) The generation of electric power or thermal energy exclusively using as its energy source wind, biomass, geothermal energy, solar energy, small irrigation power, municipal solid waste, qualified hydropower (as defined in section 45), and marine and hydrokinetic renewable energy;

2) Tipping fees paid to open loop biomass or municipal solid waste facilities for accepting or processing open loop biomass or municipal solid waste;

3) Income from the operation of energy investment credit property (as defined in section 48(a)(3)) without regard to any date by which the construction of such property must begin;

4) The production, storage, or transportation of any fuel which (1) uses as its primary feedstock carbon oxides captured from an anthropogenic source or the atmosphere, (2) does not use as its primary feedstock carbon oxide which is deliberately released from naturally occurring subsurface springs, and (3) is determined by the Secretary, in consultation with the Secretary of Energy and the EPA Administrator to achieve a reduction of not less than a 60% in lifecycle greenhouse gas emissions (as defined in section 211(o)(1)(H) of the Clean Air Act, as in effect on the date of the enactment of this clause) compared to baseline lifecycle greenhouse gas emissions (as defined in section 211(o)(1)(C) of such Act, as so in effect); and

5) Income from the operation of a facility that qualifies under section 45Q(d) (without regard to any sunset date).

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

The JCT has estimated that the proposal would lose approximately $975 million over a 10-year period.

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KPMG observation

Publicly traded partnerships are a popular source of equity financing for partnerships that earn 90% or more of their gross income from certain natural resources activities and/or from certain buckets of passive income, such as interest and dividends. The inclusion by the proposal of green energy projects in the category of assets that produces good qualifying income would provide an additional form of financing for green energy developers. Some green energy developers have previously raised funding via a publicly traded C corporation YieldCo, which is effectively a synthetic publicly traded partnership that is taxed as a corporation but builds up enough tax “shield” (generally in the form of accelerated depreciation) so that the YieldCo does not pay entity-level taxes on a current year basis.

Given that the YieldCo IPO market is extremely slow and the only YieldCos that remain in the marketplace have strong green energy developers as sponsors, it remains to be seen whether the inclusion of green energy assets in a publicly traded partnership structure would be a boon for most green energy developers and/or whether it would lead to current YieldCos converting to partnership status. This is especially true given the complicated and expensive nature of compliance for a publicly traded partnership, particularly with respect to section 704(c) allocations and the need for units in a publicly traded partnership to be fungible. Finally, the fact that a YieldCo issues a Form 1099 to its investors, in contrast to K-1s issued by publicly traded partnerships, can lead to a broader investor base as some potential investors either shy away from or cannot invest.
Zero-emission nuclear power production credit

The proposal includes a new credit for the production of electricity from a qualified nuclear power facility.

A qualified nuclear power facility is any nuclear facility that is owned by the taxpayer, that uses nuclear energy to produce electricity, was not previously awarded a credit allocation under section 45J, and is placed in service before date of enactment. For purposes of this credit, a facility may only be treated as qualified if no portion of which is a qualified facility for purposes of the zero-emissions facility credit.

If wage and apprenticeship requirements are satisfied a credit equal to 1.5 cents per kilowatt hour is available. The credit is then reduced as the sales price of electricity increase. The phase out operates by reducing the credit for any year by 80% of the excess of gross receipts from electricity produced and sold over the product of 2.5 cents and the amount of electricity sold.

If the wage and apprenticeship requirements are not satisfied a credit equal to 0.3 cents per kilowatt hour is available. In this case the credit is phased out by reducing the credit for any year by 80% of the excess of gross receipts from electricity produced and sold over the product of 0.5 cents and the amount of electricity sold.

Under the proposal the zero-emissions nuclear power production credit would be refundable under a direct pay election.

This provision would terminate on December 31, 2026. This provision would apply to electricity produced and sold after December 31, 2021, in tax years beginning after such date.

The JCT has estimated that the proposal would lose approximately $15.9 billion over a 10-year period.

Renewable fuels

Extend tax incentives for biodiesel (including renewable diesel), agri-biodiesel, biodiesel mixtures, alternative fuel, and alternative fuel mixtures

For periods beginning after December 31, 2021 and before January 1, 2032, the proposed legislation would extend:

- Biodiesel (including renewable diesel) and biodiesel mixture tax incentives of $1.00 per gallon,
- Small agri-biodiesel producer credit nonrefundable income tax credit of $0.10 per gallon, and
- Alternative fuel and alternative fuel mixture tax incentives of $0.50 per gallon.

The JCT has estimated that the proposal would lose approximately $32.9 billion over a 10-year period.

Extend tax incentives for second generation biofuel

For periods beginning after December 31, 2022 and before January 1, 2032, the proposed legislation would extend the second-generation biofuel producer nonrefundable income tax credit of up to $1.01 per gallon.
The JCT has estimated that the proposal would lose approximately $238 million over a 10-year period.

**Provide tax incentives for sustainable aviation fuel**

For periods beginning after December 31, 2022 and before January 1, 2032, the proposed legislation would provide tax incentives for each gallon of certified sustainable aviation fuel in a qualified mixture that is sold for use or used as a fuel in aviation during the tax year. The credit would be:

- $1.25 per gallon of sustainable aviation fuel that has a lifecycle greenhouse gas emissions reduction percentage of at least 50% in comparison with petroleum-based jet fuel, plus
- A supplementary credit of up to $0.50 per gallon for each percentage point by which the lifecycle greenhouse gas emissions reduction percentage exceeds 50%.

The proposed legislation provides that “qualified mixture” means a mixture of sustainable aviation fuel and kerosene that is produced in the United States, in the ordinary course of the producer’s trade of business, for sale or use in an aircraft and is transferred into the fuel supply tank of the aircraft in the United States. “Sustainable aviation fuel” means liquid fuel that meets ASTM International Standard D7566 or the Fischer Tropsch provisions of 10 ASTM International Standard D1655, Annex A1; however, it is not derived from palm fatty distillates or 13 petroleum. Sustainable aviation fuel is excluded from the definitions of biodiesel and renewable diesel.

The proposed legislation provides a specified certification methodology. In addition, the Treasury Department is required to established optional certification procedures within two years of enactment.

The incentive is to be claimed by the mixture producer in only one of the following ways:

- A nonrefundable general business tax credit under new section 40B,
- An excise tax credit against section 4081 excise tax (and payment in excess of excise tax liability) under sections 6426 and 6427, or
- A refundable income tax credit under section 34.

The producer is required to be registered by the IRS as a condition to allowance of the incentives.

The section 40B credit would be included in income under section 87.

The JCT has estimated that the proposal would lose approximately $618 million over a 10-year period.

**KPMG observation**

Although the proposed legislation would require the qualifying mixture to be produced in the United States, it would not require the sustainable aviation fuel to be produced in the United States; thus, the credit would be allowable with respect to imported sustainable aviation fuel, absent limiting language. Similarly, the proposed legislation would require the mixture to be transferred into the fuel supply tank of the aircraft in the United States but would not require the air transportation to be domestic. This would be consistent with an intention to increase use of sustainable aviation fuel in both domestic and international aviation.

The claimant in the proposed legislation would be the mixture producer, who might not be the
producer of the sustainable aviation fuel. The IRS may establish procedures similar to the existing “biodiesel certificate” requirements as part of its certification procedures for mixture producers to substantiate the claim.

The proposed legislation would require the producer of the sustainable aviation fuel to be registered but does not include such registration under existing section 4101, unlike similar current registrations for biodiesel and alcohol producers. Application for section 4101 registration is made on Form 637, Application for Registration (For Certain Excise Tax Activities). The IRS may establish procedures for registration that are consistent with existing procedures.

Although the proposed legislation would include section 40B in income under section 87, it is silent with respect to claims made under sections 34, 6426, and 6427. The income tax implications of claims made under sections 34, 6426, and 6427 are expected to be consistent with the conclusions of Sunoco, Inc. v. United States, 129 Fed. Cl. 322 (2016), aff’d 908 F.3d 710 (Fed. Cir. 2018), cert denied No. 18-1474 (October 7, 2019) (relating to income tax implications of alcohol mixture credits). In Sunoco, the alcohol mixture credits are treated as reducing excise tax liability and therefore reduces the deduction associated with any excise taxes.

To the extent sustainable aviation fuel is taxable fuel within the meaning of section 4083, it would be subject to excise tax under section 4081. The IRS may provide guidance on this issue similar to the guidance it provided with respect to renewable diesel.

Clean hydrogen

The proposal would create a new tax credit for the production of clean hydrogen produced by a taxpayer at a qualified clean hydrogen production facility during the 10-year period beginning on the date such facility is placed in service. The new tax credit, the “clean hydrogen production credit” under new section 45X, would be effective beginning in 2022.

For any tax year, the credit is an amount equal to the product of (1) the applicable amount multiplied by (2) the kilograms of qualified clean hydrogen produced by the taxpayer at a qualified clean hydrogen production facility during the 10-year period beginning on the date the facility was placed in service. The applicable amount would be an amount equal to the applicable percentage of $0.60. There is an enhanced credit amount of the applicable percentage of $3.00 when certain wage and workforce requirements are met.

The applicable percentage is 20% in the case of qualified clean hydrogen that is produced through a process that, as compared to hydrogen produced by steam methane reforming, achieves a percentage reduction in lifecycle greenhouse gas emissions which is at least 40% but less than 75%. If the percentage reduction is at least 75% but less than 85%, the applicable percentage is 25%. If the percentage reduction is at least 85% but less than 95%, the applicable percentage is 34%. If the percentage reduction is at least 95%, the applicable percentage is 100%.

The proposal would provide a series of definitions of purposes of new section 45X.

- The term “lifecycle greenhouse gas emissions” would have the same meaning given such term under subparagraph (H) of section 211(o)(1) of the Clean Air Act as in effect on the date of enactment of this proposal.
- “Qualified clean hydrogen” would mean hydrogen that is produced through a process that, as compared to hydrogen produced by steam-methane reforming of non-renewable natural gas,
achieves a percentage reduction in lifecycle greenhouse gas emissions of at least 40%.

- The term does not include any hydrogen that is properly allocable to another general business credit or under subchapter B of chapter 65 of subtitle F (such as the alternative fuel excise tax credit and payment provisions). The hydrogen must be produced in the United States or a possession of the United States in the ordinary course of a trade or business of the taxpayer for sale or use.

- A “qualified clean hydrogen production facility” is a facility owned by the taxpayer that produces qualified clean hydrogen. To qualify for the enhanced credit, a qualified clean hydrogen production facility must also satisfy certain wage and workforce requirements described below.

- The term “steam-methane reforming” means a hydrogen production process in which high-temperature steam is used to produce hydrogen from natural gas, without carbon capture and sequestration.

A qualified clean hydrogen facility would have to begin construction by December 31, 2028 to be eligible for the clean hydrogen production credit.

There would be an enhanced credit rate if taxpayers satisfy:

1) A prevailing wage requirement for the full construction period, and for any alteration or repair of such facility during the 10-year credit period; and

2) Apprenticeship requirements during the construction, alteration, or repair of such facility.

Taxpayers may elect to receive a direct payment in lieu of this credit under rules described above providing for an elective payment for energy property and electricity from certain renewable resources.

Notably, the proposal permits a taxpayer to receive both the section 45 credit for electricity produced from renewable resources and the credit for the production of clean hydrogen. The electricity would be treated as sold to an unrelated person if such electricity were used at a qualified clean hydrogen energy facility to produce clean hydrogen.

In lieu of the clean hydrogen production credit, the proposal would permit a taxpayer to elect to treat clean hydrogen facilities (or any portion of such facility) as energy property. The energy percentage with respect to such property ranges from six to 30% depending on the type of qualified clean hydrogen that the facility is designed and reasonably expected to produce.

Finally, the proposal would terminate the alternative fuel excise tax credit as it relates to hydrogen.

The JCT has estimated that the proposal would lose approximately $9.1 billion over a 10-year period.

**KPMG observation**

Similar to the proposal for the zero emissions facility credit, the clean energy hydrogen production credit indicates an intent to incentivize clean energy while being agnostic as to the technology used to generate clean energy.

A taxpayer who produces electricity from green energy and uses such electricity in the production
Green energy and efficiency incentives for individuals

Extension, increase, and modifications of nonbusiness energy property credit

Current law 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 is scheduled to expire December 31, 2021.

The proposal would provide for general modifications as well as expansions to the nonbusiness energy property credit under section 25C. The provisions are as follows:

1) Increase the credit percentage from 10% to 30% for installing qualified energy efficiency improvements;
2) Replacement of the lifetime cap on credits with a $1,200 annual credit limitation;
3) Updates to the rules to reflect advances in energy efficiency, while also removing eligibility of roofs and advanced main air circulating fans;
4) Requirement for taxpayers and manufacturers to comply with reporting the identification number of certain property placed in service in order to access the credit; and
5) Expansion of the credit to cover the costs of home energy audits with a 30% credit available for such costs, up to a maximum credit of $150.

The proposal generally would be effective for property placed in service after December 31, 2021.

The JCT has estimated that the proposal would lose approximately $14.9 billion over a 10-year period.

Residential energy efficient property

Current law section 25D provides a tax credit for installing renewable energy property in a residence. Generally, the credit is 26% if property is placed in service in 2021 or 2022, 22% if placed in service in 2023, with a complete phaseout thereafter. Property eligible for the section 25D credit includes solar electric, solar water heating, fuel cell, small wind, or geothermal heat pump properties.

The proposal would extend the section 25D credit for 10 years, through the end of 2033. The phaseout rules would be modified to provide a 30% credit for property placed in service from 2022 to 2031, a 26% credit for property placed in service in 2032, and a 22% credit for property placed in service in 2023.

The proposal also would add qualified battery storage technology expenditures to the list of expenditures that are eligible for the section 25D credit. A qualified battery storage technology expenditure is an expenditure for battery storage technology (1) installed in connection with a dwelling unit located in the United States used as a residence by the taxpayer that (2) has a capacity of not less than three kilowatt hours.
The proposal would be effective for expenditures made after December 31, 2021.

The JCT has estimated that the proposal would lose approximately $21 billion over a 10-year period.

**Energy efficient commercial buildings deduction**

Current law 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 make three meaningful changes to section 179D:

1) Modification of efficiency standard—the proposal would only require a building to increase its efficiency relative to a reference building by 25%, as compared to 50% under current law.

2) Maximum amount of deduction—the proposal would change the maximum energy efficient commercial buildings deduction to an amount equal to $0.50 per square foot, increased (but not above $1.00) by $0.02 for each percentage point by which the total annual energy and power costs for the building are certified to be reduced by a percentage greater than 25%. There is a bonus credit rate of $2.50 per square foot, increased by $0.10 per square foot for every percentage point by which designed energy cost savings exceed 25% against the reference standard, not to exceed $5.00 per square foot. These amounts would be adjusted for inflation. The maximum amount represents the total section 179D deduction that may be claimed for a building for the current tax year plus the three preceding tax years.

3) Alternative deduction for energy efficient retrofit building property—the proposal would allow a taxpayer to elect to take a deduction for the tax year which includes the date of a building’s qualifying final certification with respect to a qualified retrofit plan. The amount of the deduction is equal to the lesser of (1) the maximum amount described above or (2) the aggregate adjusted basis of energy efficient retrofit building property placed in service by the taxpayer pursuant to such qualified retrofit plan.

Energy efficient building property is depreciable (or amortizable) property installed on or in any qualified building, which is installed as part of the interior lighting systems, the heating, cooling, ventilation, and hot water systems, or the building envelope, and which is certified under rules provided in the Code. A qualifying building must be located in the United States and be at least five years old before the establishment of the qualified retrofit plan with respect to such building.

A qualified retrofit plan is a written plan prepared by a qualified professional which specifies modifications to a building which, in the aggregate, are expected to reduce such building’s energy usage intensity by 25% or more in comparison to the baseline energy usage intensity of such building. The baseline energy usage intensity means, simply, the energy usage intensity certified by a qualified professional prior to the retrofit, with potential adjustments to take into account weather.

For tax-exempt entities, the proposal would offer the ability to allocate the deduction to the person primarily responsible for designing the property (effectively giving the tax-exempt entity a discount).

To claim the bonus deduction amount, taxpayers would have to satisfy:

1) A prevailing wage requirement for the full construction period; and
2) Apprenticeship requirements during the construction of the project; each as discussed in more detail
The proposal generally would be effective for tax years beginning 2022 or later. The alternative deduction for energy efficient retrofit property would be effective for property placed in service in 2022 or later, in tax years ending after such date, if such property were placed in service pursuant to a qualified retrofit plan established after such date.

The JCT has estimated that the proposal would lose approximately $626 million over a 10-year period.

**Extension, increase, and modifications of new energy efficient home credit**

Current law 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.

For single family homes, the proposal would extend the section 45L credit through 2031 and increase the credit to $2,500, generally, for energy efficient single family and manufactured new homes meeting certain Energy Star requirements. The credit can increase to $5,000 for eligible single family and manufactured new homes certified as zero energy ready under the Department of Energy Zero Energy Ready Home Program.

For multifamily homes, there is a base credit of $500 and a bonus credit of $2,500 for multifamily units which meet certain Energy Star requirements. The credit can increase to a base credit of $1,000 and a bonus credit of $5,000 for eligible multifamily units certified as zero energy ready under the Department of Energy Zero Energy Ready Home Program.

To claim the bonus deduction amount for a multifamily unit, taxpayers would have to satisfy a prevailing wage requirement for the full construction period.

The proposal would be effective for dwelling units acquired in 2022 or later.

The JCT has estimated that the proposal would lose approximately $2.7 billion over a 10-year period.

**Modifications to income exclusion for conservation subsidies**

Current law section 136 provides that a taxpayer’s gross income shall not include the value of any subsidy provided (directly or indirectly) by a public utility to a customer for the purchase or installation of any energy conservation measure.

The proposal would expand this income exclusion for the following amounts:

1) Amounts provided (directly or indirectly) by a public utility to a customer, or by a state of local government to a resident of such state or locality, for the purchase or installation of any water conservation or efficiency measure;

2) Amounts provided (directly or indirectly) by a storm water management provider to a customer, or by a state or local government to a resident of such state or locality, for the purchase or installation of any storm water management measure; or

3) Amounts provided (directly or indirectly) by a state or local government to a resident of such state or locality for the purchase or installation of any wastewater management measure, but only if such measure is with respect to the taxpayer’s principal residence.
The proposal would be effective retroactively for amounts received after December 31, 2018.

The JCT has estimated that the proposal would lose approximately $48 million over a 10-year period.

**Greening the fleet and alternative vehicles**

**Refundable new qualified plug-in electric drive motor vehicle credit for individuals (section 136401)**

Under current law, the section 30D tax credit available for qualified plug-in electric vehicles is between $2,500-$7,500 and phases out beginning with the second calendar quarter following the calendar quarter which includes the first date on which the number of vehicles manufactured by the manufacturer after December 31, 2009, for use in the United States is at least 200,000.

The proposal would make the credit refundable for new qualified plug-in electric drive motor vehicles placed into service by the taxpayer during the tax year. The amount of credit would be increased to a base amount of $4,000 plus an additional $3,500 for vehicles placed into service before January 1, 2027 with battery capacity no less than 40 kilowatt hours, and for vehicles with battery capacity of no less than 50 kilowatt hours thereafter.

The credit amount allowed for a qualified vehicle would be increased by $4,500 if the final assembly of the vehicle is at a facility in the United States which operates under a union-negotiated collective bargaining agreement. The amount of credit allowed for a qualified vehicle would be increased by $500 if the vehicle model is assembled by a manufacturer which utilizes no less than 50% domestic content in component parts of such vehicles and such vehicles are powered by battery cells which are manufactured within the United States.

The amount of credit allowed for a qualified vehicle would be limited to 50% of its purchase price.

Beginning in 2027, this credit would only apply with respect to vehicles for which final assembly is within the United States.

No credit would be allowed for vehicle by which the manufacturer’s suggested retail price exceeds the applicable limitation, which is as follows:

- Sedans: $55k
- Vans: $64k
- SUVs: $69k
- Pick-up trucks: $74k

The credit would be phased out by $200 for each $1,000 of the taxpayer’s modified adjusted gross income as exceeds $800,000 for married filing jointly, $600,000 for head of household, and $400,000 in any other case.

The taxpayer could elect to transfer the credit to the vehicle dealer, provider the dealer is registered as an eligible entity with the Secretary, discloses the MSRP, credit amount, associated fees, and the amount to be paid to the taxpayer in the form of a down payment or otherwise with respect to the transfer of credit. The Secretary would establish a program to make advance payments to any eligible dealer equal to the cumulative amount of transferred credits.
This proposal would provide for a 10% credit, not to exceed $2,500, for two and three wheeled plug in electric vehicles which have a battery capacity of no less than two and a half kilowatt hours, are manufactured primarily for use on roads and highways, and are capable of achieving a speed of 45 miles per hour or greater, and otherwise meet the requirements of this section.

This provision would be effective beginning after December 31, 2021, replacing section 30D, the plug-in electric drive motor vehicles credit. No credit would be allowed under this provision for vehicles acquired after December 31, 2031.

The proposal to allow for transfer of the credit would be effective for vehicles purchased or leased after December 31, 2022.

The JCT has estimated that the proposal would lose approximately $15.6 billion over a 10-year period.

**KPMG observation**

The modifications to section 30D in the proposal would result in a substantial enhancement and overhaul to the credit. Under the proposal, a taxpayer could be potentially be eligible to receive a refundable tax credit of up to $12,500, for a vehicle that meets the battery capacity, domestic assembly and collective bargaining, and domestic content standards listed above.

The proposal indicates that current law section 30D would be replaced by the modification as of January 1, 2022, indicating that vehicles impacted by the current law 200,000 threshold would once again be eligible for credit, provided the other applicable requirements are satisfied.

**Credit for previously owned qualified plug-in electric drive motor vehicles (section 136402)**

The proposal would provide a new credit for previously owned qualified plug-in electric drive vehicles. Buyers could claim a base credit of $1,250 for the purchase of qualifying used EVs, with additional incentives for battery capacity. The credit is capped at the lesser of $2,500 credit or 30% of the sale price. The credit would be refundable.

Buyers with up to $75,000 ($150,000 for married couples filing jointly and $112,500 for head of household filers) in adjusted gross income could claim the full amount of the credit. The credit would phase out by $200 for every $1,000 in AGI in excess of the limitation. Buyers would have to purchase the vehicle from a dealership for personal use and could not claim the credit more than once every three years. The credit would only apply to the first resale of a used EV and includes restrictions on sales between related parties.

The credit would apply to vehicles acquired after December 31, 2021.

The JCT has estimated that the proposal would lose approximately $1.4 billion over a 10-year period.

**Credit for qualified commercial electric vehicles**

This proposal would create a new credit for qualified commercial electric vehicles placed into service by the taxpayer. The amount of credit allowed by this provision with respect to a qualified commercial electric vehicle would be equal to 30% of the cost of such vehicle. In the case of vehicles acquired by tax exempt entities, the person who sold the qualified vehicle to such entity would be treated as the
taxpayer that placed such vehicle into service.

Among other requirements, in order to a qualified commercial electric vehicle, the vehicle must be propelled to a significant extent by an electric motor which draws electricity from a battery which has a capacity of not less than 10 kilowatt hours and is capable of being recharged from an external source of electricity, or is a fuel cell vehicle based upon the requirements of section 30B.

This provision would take effect after December 31, 2021. No credit would be allowed under this provision for a vehicle acquired after December 31, 2031.

The JCT has estimated that the proposal would lose approximately $11.6 billion over a 10-year period.

**Qualified fuel cell motor vehicles**

This proposal would extend the credit for the purchase of a qualified fuel cell motor vehicle through 2031, but only with respect to vehicles not of a character subject to depreciation. Beginning on January 1, 2022, commercial fuel cell vehicles otherwise eligible for this credit would be eligible for the new credit for qualified commercial electric vehicles.

The JCT has estimated that the proposal would lose approximately $44 million over a 10-year period.

**Alternative fuel refueling property 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 extend the expiration date for the alternative fuel refueling property credit for 10 years (through December 31, 2031).

The proposal would increase the per location limitation to $100,000 (from $30,000) for depreciable property and $3,333.33 (from $1,000) in any other case.

Beginning in 2022, the proposal would expand the credit for zero- emissions charging infrastructure by providing a base credit of 6% for expenses up to $100,000 and 4% for allowable expenses in excess of such limitation (i.e., it allows a credit for expenses beyond the limit if certain requirements are met). The proposal would provide an alternative bonus credit level of 30% for expenses up to $100,000 and 20% thereafter.

To qualify for the credit for expenses in excess of the $100,000 limitation, the property must: 1) be intended for general public use and either accept credit cards as a form of payment or not charge a fee, or 2) be intended for exclusive use by government or commercial vehicle fleets. In order to claim the bonus credit amount with respect to eligible property, taxpayers must satisfy prevailing wage and apprenticeship requirements for the duration of the construction of such property.

Taxpayers could elect to make the credit refundable through a direct pay mechanism.

The proposal would be effective for property placed in service after December 31, 2021. No credit would be allowed for any property placed in service after December 31, 2031.

The JCT has estimated that the proposal would lose approximately $6.3 billion over a 10-year period.
Reinstatement and expansion of employer-provided fringe benefits for bicycle commuting

The proposal would repeal the suspension of the qualified bicycle commuting fringe benefit under section 132(f) and expand the benefit to include employer reimbursement of reasonable expenses incurred by an employee for purchase, lease, rental, improvement, repair or storage of a “qualified commuting property” so long as the property is regularly used for travel between the employee’s residence and place or employment or to mass transit facility that connects to place of employment or residence. “Qualified commuting property” includes bicycles, e-bikes, scooters, e-scooters (not to exceed 100 pounds or 20 miles per hour), and bikeshares. The exclusion would be limited to 30% of the amount allowed for qualified parking, which is currently $270 per month for 2021, but is indexed annually.

The changes are proposed to be effective for tax years beginning after December 31, 2021.

The JCT estimated that the provision would decrease revenues by approximately $183 million over a 10-year period.

Credit for certain new electric bicycles

This proposal would provide for a 15% refundable tax credit for qualified electric bicycles placed into service before January 1, 2032.

Under the proposal, taxpayers could claim a credit of up to $1,500 for electric bicycles placed into service by the taxpayer for use within the United States. A taxpayer could claim the credit for one electric bicycle per tax year (two for joint filers).

The JCT has estimated that the proposal would lose approximately $7.4 billion over a 10-year period.

Investment in the green workforce

Extension of the advanced energy project credit

The 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 proposal would allow the Secretary to allocate an additional $2.5 billion in credits for each year from 2022 through and including 2031. $400 million in credits each year is reserved for projects in automotive communities.

In order for a project to be eligible for the advanced energy project credit, taxpayers must satisfy

1) Prevailing wage requirements for the establishment, expansion, or re-equipping of a manufacturing facility and for five years after the project is placed into service, and
2) Apprenticeship requirements during the construction of the project.

Similar requirements to the original credit would apply, with a few notable changes. The Secretary would determine allocations to projects each year with a requirement that property is placed in service within four years of the date of the allocation. Projects would be given priority if the manufacturing is not for the assembly of parts or if they have the greatest potential for commercial deployment of new applications.

Additionally, the Secretary would give consideration to projects with the greatest net impact in reducing greenhouse gas emissions, the greatest domestic job creation, and greatest job creation in historically underserved communities whose population is at significant risk of experiencing adverse health and environmental effects of greenhouse gas emissions.

Taxpayers could elect to make the credit refundable through a direct pay mechanism.

The Secretary of Treasury would have to establish a certification program no later than 180 days after the date of enactment this proposal.

The JCT has estimated that the proposal would lose approximately $2.1 billion over a 10-year period.

**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 previous iteration of the section 48C credit generally has not been monetized through application of tax equity investment.

**Qualified environmental justice program credit**

The proposal would create a new refundable tax credit for eligible educational institutions that incur costs during the tax year as part of a qualified environmental justice program. Under the proposal, eligible institutions would apply to the Secretary for an allocation of credit for an applicable percentage of costs incurred with respect to their qualified environmental justice programs.

The applicable percentage would be 30% with respect to a program involving material participation of faculty and students of Historically Black Colleges and Universities (HBCUs) and Minority Serving Institutions (MSIs), and 20% in all other cases.

The Treasury Secretary would be authorized to allocate $1 billion per year for the period 2022 through 2031 to the selected eligible institutions. In consultation with the Secretaries of Energy, Education, and Health and Human Services, the Treasury Secretary would select programs for an allocation of credit based on the following criteria:
• The extent of participation of faculty and students from HBCUs and MSIs
• The extent of the expected effect on the health or economic outcomes of individuals residing in areas within the United States that are low-income areas or areas that experience, or are at risk of experiencing, multiple exposures to qualified environmental stressors
• The creation or significant expansion of qualified environmental justice programs

Qualified environmental stressors with respect to an area would include a contamination of the air, water, soil, or food with respect to such area or a change relative to historical norms of the weather conditions of such area. Qualified environmental justice programs are those designed to address or improve data about environmental stressors for the primary purpose of improving or facilitating the improvement of health and economic outcomes of individuals residing in low-income areas or areas that experience, or at risk of experiencing, multiple exposures to qualified environmental stressors.

The proposal would require the Treasury Secretary to publish the identity of each institution receiving an allocation of credit and the amount of the allocation. Applicants selected to receive an allocation would be required to make their submitted applications publicly available and to report annually to the Secretary the amounts paid or incurred and the expected impact of the project. Failure to comply with these requirements would reduce the eligible educational institution’s allocation to zero.

The eligible educational institution would have five years after receiving an allocation to incur costs eligible for the credit. The amount of credit for any tax year would be limited to the credit dollar amount allocated to such program less any credits previously claimed for such program.

The proposal would be effective on the date of enactment.

The JCT has estimated that the proposal would lose approximately $5 billion over a 10-year period.

**Reinstatement of Superfund excise taxes on crude oil and imported petroleum products**

For periods beginning after December 31, 2021, the proposed legislation would reinstate the Hazardous Substance Superfund tax ("Superfund tax") at a rate of 16.4 cents per barrel. The Superfund tax is indexed for inflation beginning in calendar year 2023.

The revenues from Superfund the tax would be dedicated to the Hazardous Substance Superfund Trust Fund.

The JCT has estimated that the proposal would increase revenues by approximately $38.4 billion over a 10-year period.

**KPMG observation**

Upon reinstatement, domestic crude and imported petroleum products would be subject to both the 16.4 cents per barrel Superfund tax and the 9 cents per barrel Oil Spill Liability Trust Fund Tax ("Oil Spill tax"). Thus, in calendar year 2022, the total tax per barrel would be 26.1 cents per barrel.

Reinstatement of the Superfund excise tax on hazardous chemicals, which expired in 1995, is included in the bipartisan infrastructure bill that passed the Senate in August.
Social safety net

Child tax credit

The JCT estimated that the various provisions related to the child tax credit would have a combined impact of decreasing revenues by approximately $556 billion over 10 years.

Modifications to child tax credit applicable beginning in 2021

While ARPA made several temporary modifications to the child tax credit (CTC) for the 2021 tax year, one of the more significant changes was the addition of a new section that directed the Treasury to establish a temporary program for making advanced periodic payments to eligible 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. 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 modified adjusted gross income (MAGI).

The proposal would modify the safe harbor rule by providing that the safe harbor would not apply if the Secretary determines that a child was taken into consideration for the advance payment due to fraud or intentional disregard of rules and regulations by the taxpayer.

The proposal would also expand the information the Secretary is able to consider in determining eligibility for, and the amount of, the advance payments. Under current law, the Secretary is limited to considering the information included on an individual’s prior year tax return. Under the proposal, the Secretary would be able to consider any information known to the Secretary.

In addition, in the case of an advance payment made with respect to a joint return, the proposal would treat half of the advance payment as being made to each individual filing the return.

The proposal would apply to tax years beginning, and payments made, after December 31, 2020.

Extension and modification of child tax credit and advance payment for 2022

Taxpayers may claim a 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 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 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 to which that taxpayer is entitled, 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 an 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 2022. However, the proposal includes several modifications to the CTC and advance payment rules that would only apply to tax year 2022. The proposal would:
• Change the MAGI used for purposes of the income phaseout of the CTC to be the MAGI of the taxpayer for the preceding tax year (2021) if it is less than the taxpayer’s MAGI for the current tax year (2022);

• Adjust the CTC, ODTC, and phase-out thresholds applicable to the additional CTC amount provided under ARPA for inflation;

• Increase the safe harbor amount to $3,000 ($3,600 for a child under the age of 6) for certain taxpayers in cases when repayment may be required because the advance CTC payment amount received during the year exceeds the CTC amount allowed on their tax return (these increased safe harbor amounts would be adjusted for inflation to match the CTC amounts); and

• Eliminate the 50% limit on advance payments that was in effect for tax year 2021, with the result that advance payments would be made for the full 2022 tax year, rather than for half the year as in 2021.

The proposal would also eliminate the SSN requirement for a qualifying child that was added to the CTC rules by the TCJA. Thus, under the proposal, the CTC may be claimed if any valid TIN (such as an ITIN) of the qualifying child appears on the return, as long as the TIN is issued on or before the due date of the return.

The proposal would apply to tax years beginning, and payments made, 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 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 2021 exceeds the CTC amount that 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 2021 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 enacted, the proposal may result in more taxpayers having their federal income tax liability increased by excess advance CTC payments because taxpayers would now be receiving estimated advance payments of their full CTC amount as opposed to half of that amount, as was the case in
Establishment of monthly child tax credit with advance payment through 2025

Monthly child tax credit

For tax years 2023 through 2025, the proposal would create a new monthly refundable CTC that would replace the existing CTC. Under the proposal, the CTC allowed in a tax year would be the sum of the “monthly specified child allowances” for each month of that tax year. The allowance amount for any month would be $250 for each “specified child,” or $300 if the specified child would not have reached age six by the end of the tax year.

The CTC would be fully refundable for any month in which the taxpayer (or at least one of the spouses in the case of a joint return) has a principal place of abode in the United States or Puerto Rico for more than half of the month.

The monthly allowance amount would be reduced under two separate phaseouts. The “initial phaseout” would apply to taxpayers with MAGI in excess of an applicable threshold ($75,000 for a married individual filing a separate return, $150,000 for married couples filing jointly, and $112,500 for all other taxpayers). Taxpayers with MAGI in excess of $400,000 if married filing jointly ($300,000 for head of household, and $200,000 for all other taxpayers) would also be subject to a “secondary phaseout.” For both phaseouts, the monthly allowance would be reduced by one-twelfth of 5% of the excess of the taxpayer’s MAGI over the applicable threshold amount. However, the initial phaseout is limited so the monthly allowance amount is not reduced below $166.67.

MAGI used for purposes of the income phaseout is the lower of the MAGI of the taxpayer for the current tax year or the two preceding tax years. Any amount excluded under section 911 (foreign earned income exclusion), 931 (exclusion of income for a bona fide resident of American Samoa), or 933 (exclusion of income for a bona fide resident of Puerto Rico) is added back to AGI in order to calculate MAGI for purposes of the limitation.

Under the proposal, the monthly allowance amount and first phaseout threshold would be indexed for inflation beginning in tax year 2023.

Under the proposal, a specified child is a child who in a given calendar month:

- Has the same principal place of abode as the taxpayer for more than one-half of the month,
- Is younger than the taxpayer and would not, as of the close of the tax year which includes such month, reach age 18,
- Receives care from the taxpayer during the month that is not compensated,
- Is not the spouse of the taxpayer during the month,
- Is not a taxpayer with respect to whom any child is a specified child for the month, and
- Is either a citizen, national or resident of the United States (or if the taxpayer is a citizen or national of the United States, a child who is legally adopted by the taxpayer or is lawfully placed with the taxpayer for legal adoption by the taxpayer).

Special rules regarding the birth and death of a specified child would apply. A taxpayer claiming a specified child born or deceased during the tax year would receive a monthly specified child allowance for the entire year (e.g., a December birth results in 12 monthly allowances for the year of birth).
The proposal would direct Treasury to make monthly advance payments of the monthly CTC. The amount of the monthly advance payment would be determined based on the number and ages of specified children and the taxpayer’s MAGI as reported for the preceding tax year if a tax return was filed for that year, or information provided by the taxpayer through a specified alternative mechanism (including the on-line portal) which is sufficient to estimate the monthly advance payment. Monthly advance payments would only be made if the taxpayer (in the case of a joint return, either spouse) has a principal place of abode in the United States or Puerto Rico for more than one-half of the month.

Under the proposal, a taxpayer would need to establish “presumptive eligibility” with respect to a specified child before the taxpayer would be able to claim the monthly CTC and receive monthly advance payments for that child. The proposal provides that in order to establish presumptive eligibility for a month, a taxpayer would be required to express a reasonable expectation and intent that the taxpayer would continue to be eligible to claim the child as a specified child for at least two months after the month for which presumptive eligibility is established. Presumptive eligibility would need to be renewed annually, and would be established by providing information on the prior-year tax return, through an online portal, or by other means as would be established by the IRS. Also, presumptive eligibility would generally provide protection from “recapture” of excess advance payments.

The proposal provides that a taxpayer who does not elect to receive advance payments may establish a period of presumptive eligibility for a specified child for the purpose of claiming the monthly CTC on a tax return.

In order to claim this proposed CTC, a taxpayer would need to provide the name and valid TIN of the specified child on the taxpayer’s tax return. Both the child’s TIN and the taxpayer’s TIN would need to be issued on or before the due date for filing the return.

The proposal provides that the amount of the monthly CTC allowed for a year would be reduced by the advance payments received during the year, and a reconciliation would be included as part of the CTC calculation on the taxpayer’s return. As noted above, presumptive eligibility generally provides a safe harbor from recapture, when a taxpayer’s excess advance payments increase his or her tax liability. However, a taxpayer would be subject to recapture if the Secretary determines that the amount of advance payments was determined on the basis of fraud or reckless or intentional disregard of the rules, or if an advance payment was received for a month that was not part of the period of presumptive eligibility for the child. Recapture would also apply if the advance payment was based on a filing status other than the taxpayer’s filing status for the applicable tax year, or if the amount of the advance payments was based on MAGI that was less than the taxpayer’s lowest MAGI in the current tax year or the two preceding tax years. If a taxpayer is subject to recapture and receives advance payments in excess of the taxpayer’s allowable monthly CTC during a tax year, the taxpayer’s tax liability for the tax year would be increased by the excess amount.

Credit for certain other dependents

For tax years 2023 to 2025, the proposal would create a new nonrefundable other dependent credit tax credit (ODTC) that would replace the existing ODTC. Under the proposal, a taxpayer would be allowed a $500 nonrefundable credit for each “specified dependent” of the taxpayer. A specified dependent is defined as a dependent other than a specified child, who is a citizen, national, or resident of the United States.

The new ODTC would be subject to a phaseout of $50 for each $1,000 (or fraction thereof) by which a taxpayer’s MAGI exceeds $400,000 if married filing jointly ($300,000 for head of household, and $200,000 for all other taxpayers).
Similar to the new monthly CTC, a taxpayer would need to provide the name and valid TIN of the specified dependent on the taxpayer’s tax return to claim the new ODTC. Both the dependent’s TIN and the taxpayer’s TIN would need to be issued on or before the due date for filing the return.

KPMG observation

It appears that converting the existing CTC to a monthly CTC, combined with the new requirement to establish presumptive eligibility, would enable the IRS to establish better control over the advance payment system and would reflect the fact that not all dependent children would have that status for the entire year. While establishing presumptive eligibility may be burdensome for some taxpayers, the fact that advance payments would not be subject to recapture should be a welcome simplification for many recipients of the payments.

Refundable child tax credit after 2025

The refundable portion of the CTC varies based on the tax year due to the temporary provisions under the TCJA and the temporary provisions within ARPA.

Under the TCJA, for tax years 2018 through 2025, excluding tax year 2021, the CTC is generally refundable up to $1,400 per qualifying dependent child if the taxpayer has earned income in excess of $2,500 and does not claim the foreign earned income exclusion.

ARPA made the CTC fully refundable and removed the earned income requirement for tax year 2021 only.

For tax years after 2025, 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. Thus, the CTC of up to $1,000 per qualifying child may be fully refundable if the earned income requirement is met.

Proposal

The proposal would make the CTC permanently fully refundable, regardless of a taxpayer’s earned income, for all tax years after 2025 for taxpayers with a principal place of abode in the United States for more than one-half of the tax year.

This proposal would be effective for tax years beginning after December 31, 2025.

Child and dependent care tax credit

Certain improvements to the child and dependent care credit made permanent

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. The proposal’s modifications to the CDCTC are generally consistent with the modifications proposed by the Biden Administration on May 28, 2021. One notable difference between the Biden Administration’s proposal and this proposal is that this proposal would adjust the CDCTC for inflation each year.
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.

The amounts above are not indexed for inflation and have not been increased since 2001.

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 ARPA’s special, temporary modifications to the CDCTC for the 2021 tax year permanent. Additionally, the proposal would adjust the eligible expense limitation and phaseout threshold for inflation each year.

The proposal would also modify a special rule that applies for calculating earned income when one spouse is either a full-time student or mentally or physically unable of caring for themselves. Under the proposal, for each month in which the student or incapacitated spouse qualifies, the spouse is deemed to have earned income equal to one-twelfth of $8,000 (adjusted for inflation) in the case of one qualifying individual or one-twelfth of $16,000 (adjusted for inflation) if there are two or more qualifying individuals.

The proposal would make permanent the reimbursement for the cost or value of the refundable CDCTC
for U.S. territories.

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

The JCT estimated that the provision would decrease revenues by approximately $95 billion over 10 years.

KPMG observation

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

Under current law, the CDCTC amounts are not adjusted for inflation, and have not been increased since 2001. Because the CDCTC amounts are not adjusted for inflation, the benefit provided by the CDCTC diminishes with time as the cost of living increases. Under the proposal, the CDCTC amounts would be adjusted every year to keep up with inflation, thus providing the intended ongoing tax relief to qualifying families.

Increase in exclusion for employer-provided dependent care assistance made permanent

The proposal would permanently increase the exclusion for employer-provided dependent care assistance from $5,000 to $10,500. The amount would then be subject to inflation adjustment. The proposed effective date is for tax years beginning after December 31, 2021.

The JCT estimated that the provision would decrease revenues by approximately $3.3 billion over 10 years.

Supporting caregivers

Payroll tax credit for child care workers

The proposal would allow an eligible child care employer a refundable credit against Medicare taxes for each calendar quarter for 50% of the qualified child care wages paid to each eligible employee. Maximum wages taken into account would be $2,500 per quarter (subject to cost of living adjustment) for an eligible employee. An eligible child care employer must operate one or more qualified child care facilities certified as an HHS Participating Child Care Provider by HHS under section 418A(c) of the Social Security Act.

An eligible employee wage could not exceed 25% of the dollar amount in effect for determining highly compensated employees and the aggregate wage for the one-year period ending with the close of the quarter could not exceed 100% of the dollar amount under 414(q)(1)(B)(ii), which is currently $130,000 for 2021. Qualified wages are paid at a rate in excess of the “applicable minimum rate,” which is pay at a GS-3 level.

The credit is proposed to be effective for calendar quarters beginning after December 31, 2021.

The JCT estimated that the provision would decrease revenues by approximately $7.1 billion over 10 years.
Credit for caregiver expenses

The proposal would create a new temporary nonrefundable tax credit for individuals who incur caregiver expenses in relation to “qualified care recipients.” The amount of the credit would be 50% of unreimbursed qualified expenses, up to $4,000. The credit would be phased out by 1% for every $2,500 or fraction thereof by which the taxpayer’s AGI exceeds $75,000.

A qualified care recipient is defined as a spouse, child, parent, sibling, or other specified family member or member of the taxpayer’s household, who has been certified by a Medicare, Medicaid, or Children’s Health Insurance Program enrolled provider as having long-term care needs expected to be at least 180 consecutive days, a portion of which occurs within the tax year. The individual must live in a personal residence as opposed to an institutional care facility. Individuals with long-term care needs are defined as (1) those of at least six years of age who are unable to perform certain activities of daily living without substantial assistance, or who are otherwise subject to health and safety risks; (2) individuals aged two through six who require substantial assistance with eating, transferring, or mobility; and (3) individuals under the age of two who require specific durable medical equipment by reason of a severe health condition, or who require the assistance of a skilled practitioner if their parents are absent.

Qualified expenses are defined as those incurred for goods, services, and supports that assist a qualified care recipient in performing basic activities and are provided solely for use by such recipients. These include human assistance from caregivers, assistive technologies and devices, accessibility modifications of the recipient’s residence, and certain other specified expenses. The expenses must be substantiated to be eligible for the credit, under regulations or other guidance issued by the IRS. Qualified expenses under this provision would not include amounts taken into account for purposes of the child and dependent care tax credit, the exclusion for amounts paid to employees under dependent care assistance programs, the itemized deduction for medical expenses, or amounts which represent excludable distributions from a health savings accounts. In addition, no credit can be claimed in relation to expenses reimbursed by insurance or expenses paid to certain related individuals.

This provision would be effective for tax years beginning after December 31, 2021 but does not apply to tax years beginning after December 31, 2025.

The JCT estimated that the provision would decrease revenues by approximately $28.4 billion over 10 years.

KPMG observation

The caregiver credit would be available in addition to the child and dependent care tax credit and would help defray out-of-pocket costs for taxpayers providing care to elderly family members and those with additional long-term care needs.

Earned income tax credit

The earned income tax credit (EITC) is a refundable credit intended to support low- to moderate-income working families. The EITC is based on a worker’s family size, filing status, AGI, and earned income.

For childless workers, ARPA made a number of temporary changes to the EITC effective only for tax year
2021, including:

- Lowering the minimum age from 25 to 19 (18 for certain former foster and homeless youth, and 24 for certain eligible students);
- Eliminating the maximum age at which the credit was available (age 64);
- Increasing the maximum credit and phaseout percentage from 7.65% to 15.3%;
- 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;
- Increasing in earned income at which the maximum credit amount is reached from $4,220 to $9,820; and
- Increasing phaseout amount from $5,280 to $11,610.

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 an SSN may claim EITC as childless workers.

Additionally, ARPA provided a temporary special rule for 2021 that allowed a taxpayer who earned less income in 2021 than 2019 to elect to compute the EITC using the taxpayer’s 2019 earned income amount.

Proposal

The proposal would make permanent ARPA’s temporary changes to the EITC for childless workers and would adjust the relevant thresholds for inflation each year starting in 2022.

The proposal would also allow taxpayer whose earned income for any tax year is less than the taxpayer’s earned income for the prior tax year to elect to use the taxpayer’s prior-year earned income for purposes of computing the EITC.

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

The JCT estimated that the provision would decrease revenues by approximately $135.3 billion over 10 years.

There is also a proposal relating to funds for administration of the EITC in the territories.

Expanding access to health coverage and lowering costs

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 (ACA). 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.

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, 2021.

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.

Modify employer-sponsored coverage affordability test for PTC eligibility

The PTC is available to taxpayers for coverage purchased in healthcare marketplaces only if they do not have an offer of affordable, minimum value job-based coverage. Under the ACA, an employee’s job-based coverage is considered “affordable” if the employee contributes less than 9.5% of their household income towards health insurance premiums. This percentage has been indexed for inflation and, for 2021, has been adjusted to 9.83%.

The proposal would revise the threshold to determine whether a taxpayer has access to affordable insurance through an employer-sponsored plan or a qualified small employer health reimbursement arrangement to 8.5% of household income for purposes of determining PTC eligibility.

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

KPMG observation
While not eliminating the requirement that job-based coverage be affordable, the proposal has permanently eliminated any inflation indexing such that premiums must remain less than 8.5% of household income for purposes of determining PTC eligibility for all future tax years.

Exclude lump-sum social security benefits from determining PTC eligibility

Current law provides that taxpayers must include all lump-sum social security benefits in household income for the year in which the lump-sum benefit is awarded when calculating PTC eligibility.

The proposal would amend the calculation of modified adjusted gross income for purposes of calculating PTC eligibility to exclude lump-sum Social Security benefits.
The proposal would be effective for tax years beginning after December 31, 2021.

KPMG observation

Lump-sum social security benefits are generally treated as income in the year in which the amount is awarded rather than over several years for which the benefits may be earned. As a result, a lump-sum award can significantly reduce or eliminate an individual’s PTC for that year and may even require that individual to repay advance PTCs. This proposal would permanently exclude such benefits from the PTC eligibility calculation, regardless of when earned or awarded.

Temporarily expand PTC eligibility for certain low-income populations

Under current law, PTCs are only available to those whose income is above the federal poverty line and who meet certain program requirements (e.g., being ineligible for other types of minimum essential coverage, including Medicaid). In addition, taxpayers must estimate their income to be under a certain threshold to receive advance PTCs. If a taxpayer underestimates their income level and no longer qualifies for PTCs, they must repay those advance PTCs, subject to certain requirements and limitations.

Proposal

The proposal would expand eligibility of PTCs to taxpayers with household incomes below 100% of the federal poverty line. In addition, the proposal would provide that taxpayers with household incomes below 138% of the federal poverty line with access to employer-sponsored coverage or a qualified small employer health reimbursement arrangement may still receive PTCs, and the employers providing such coverage would not be subject to the employer shared responsibility payment with respect to those taxpayers. Finally, the proposal would reduce the amount of the advance PTCs that must be repaid if a taxpayer underestimated their income and received too much advance PTC.

The proposal would be effective for tax years beginning after December 31, 2021 and ending before the later of January 1, 2025, or when the Secretary of the Department of Health and Human Services has certified implementation of the federal Medicaid program in states that opted out of Medicaid expansion.

KPMG observation

It appears this proposal is intended to close the Medicaid coverage gap. This “gap” commonly refers to individuals whose income is too high to qualify for Medicaid in states that have not opted to expand Medicaid under ACA rules but too low (i.e., below the federal poverty line) to qualify for any healthcare marketplace subsidies.

Modify special premium tax credit rules for those receiving unemployment compensation

Under ARPA, an individual who has received (or is approved to receive) unemployment benefits during 2021 is treated as if their income is no higher than 133% of the federal poverty line for purposes of determining PTC eligibility.

The proposal would extend the subsidy enhancement for those receiving unemployment compensation through 2025 and adjust the income level to treat those who qualify as having an income of 150% of the
federal poverty line. The proposal would be effective for tax years beginning after December 31, 2021.

**Make permanent the credit for health insurance costs**

Section 35, which was originally enacted by the Trade Act of 2002, grants a 72.5% credit of the amount paid for qualified health coverage for an eligible taxpayer and qualifying family members for the eligible coverage month. This health coverage tax credit, which has been extended numerous times over the years since its initial enactment, is set to expire at the end of 2021.

The proposal would make permanent the health coverage tax credit and increase the amount of the qualified health insurance premium covered by the credit from 72.5% to 80%.

The JCT has estimated that the proposal would lose approximately $198 million over a 10-year period.

**Pathway to Practice medical school scholarship program**

To increase the number of medical professionals serving rural and medically underserved communities, the proposal creates a medical scholarship program. Beginning in 2023, the Secretary of Health and Human Services is to award 1,000 “Pathway to Practice” scholarship vouchers to qualified students, who commit to practice for a specified time in a rural or medically underserved area following residency. Funding of a Pathway to Practice scholarship is in the form of a refundable tax credit to the educational institution.

The JCT has estimated that the proposal would lose approximately $4.88 billion over a 10-year period.

**Higher education**

**Public university research infrastructure credit**

The proposal would provide a new general business tax credit equal to 40% of the qualified cash contributions made by a taxpayer to a certified public higher educational institution in connection with a qualifying research infrastructure program. Taxpayers could elect to claim this credit with respect to a qualifying cash contribution in lieu of treating such contributions as charitable deductions.

An institution could designate contributions made by a taxpayer as qualified cash contributions only if such institution is certified as having been allocated a credit amount by the Treasury Secretary with respect to the qualifying project. The amount of cash contributions a certified educational institution could designate as qualified cash contributions could not exceed 250% of the credit amount allocated to such institution under the proposal. For example, as explained in the JCT technical explanation, if the Treasury Secretary allocates a $100 million credit amount to a certified educational institution for a qualifying project, the institution could designate up to $250 million (250% of $100 million) in qualifying cash contributions. These qualifying cash contributions, in turn, could generate up to $100 million (40% of $250 million) in credits for taxpayers.

The proposal would provide $500 million of credits for each of calendar years 2022, 2023, 2024, 2025, and 2026 to be awarded by the Secretary to eligible institutions on a project application basis. Credit amounts allocated to any one institution for all projects could not exceed $100 million per calendar year.
An eligible educational institution is a public college or university or certain non-profit organizations to which authority has been delegated by a public college or university to apply for administering credit amounts on behalf of the college or university. To qualify as a delegee of a public college or university, a non-profit organization would have to either be a supporting organization described in section 509(a)(3) or a foundation for a state or local college or university described in section 170(b)(1)(A)(iv).

A qualifying project means a project to purchase, construct, or improve research infrastructure property. Research infrastructure property includes any portion of a property, building, or structure of an eligible educational institution, or associated land, that is used for research.

The Treasury Secretary, after consultation with the Secretary of Education, would have to select applications from eligible education institutions: (1) based on the extent of the expected expansion of the institution’s targeted research within disciplines in science, mathematics, engineering, and technology; and (2) in a manner that ensures consideration is given to institutions with full-time student populations of less than 12,000.

The proposal would require the Treasury Secretary, upon allocating credit amounts to an applicant, to publicly disclose the identity of the applicant and the credit amount allocated to the applicant. Each certified educational institution, upon designating contributions of a taxpayer as qualified cash contributions, would have to publicly disclose the identity of the taxpayer and the amount of contributions designated in such time, form, and manner as the Secretary may require.

Under the proposal, the credit amounts could be recaptured or reallocated under certain circumstances during the five-year period beginning on the date of the allocation of the credit amounts to the educational institution. For this purpose, recapture would be effectuated by treating the qualifying cash contributions as unrelated business taxable income (within the meaning of section 512) of the certified educational institution.

The proposal would be effective for qualified cash contributions made after December 31, 2021. The proposal requires the Treasury Secretary, in consultation with the Secretary of Education, to establish the allocation program within 180 days of the date of enactment. The proposal would not apply to qualified cash contributions made after December 31, 2033.

The JCT has estimated that the proposal would lose approximately $125 million over a 10-year period.

**Modification of excise tax on investment income of private colleges and universities**

The proposal would provide a phase out of the excise tax under section 4968 for certain educational institutions that provide sufficient qualified aid awards to students.

Section 4968, which was enacted as part of the Tax Cut and Jobs Act of 2017, imposes a 1.4% excise tax on the net investment income of certain private colleges and universities with at least 500 tuition-paying students and non-exempt use assets worth at least $500,000 per student.

Under the proposal, educational institutions that make qualified aid awards to students would be able to reduce the amount of section 4968 excise tax owed, potentially fully eliminating their tax liability, depending on the amount of aid given. Pursuant to the proposal, an educational institution could reduce its section 4968 tax liability by 1/13th for every percentage point by which its grant aid exceeds 20% of the aggregate undergraduate tuition and fees received by the institution from first-time, full-time undergraduate students. An educational institution could thus fully phase out its section 4968 excise tax liability by making qualified aid awards to first-time, full-time undergraduate students equal to or greater
than 33% of such aggregate tuition and fees.

The reduction in excise tax for an educational institution for a tax year would be determined by a formula whereby tax liability would be reduced by a percentage equal to:

1) The excess (if any) of (a) the aggregate amount of grants and scholarships provided by the institution to its first-time, full-time undergraduate students for tuition and fees for academic periods beginning during the tax year, over (b) an amount equal to 20% of the aggregate undergraduate tuition and fees received by the institution from first-time, full-time undergraduate students for such academic periods, divided by

2) An amount equal to 13% of such aggregate undergraduate tuition and fees.

To qualify for the reduction in excise tax, an educational institution would have to meet certain reporting requirements.

In addition, for tax years beginning after 2022, this provision would amend the 500-tuition-paying-student threshold under section 4968 (noted above) to take into account only undergraduate students and would index the $500,000-per-student asset threshold for inflation.

The JCT has estimated this provision would cost approximately $2.3 billion over 10 years.

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

**Treatment of Federal Pell grants for income tax purposes**

The proposal would make Federal Pell grants fully excludible from gross income. Under current law, Federal Pell grants, which are a form of needs-based federal financial aid for college expenses, are excludible from gross income only if applied to qualified educational expenses such as tuition, and books, supplies and equipment required for the recipient’s course of instruction.

In addition, the proposal would treat Federal Pell grants like qualified scholarships for purposes of calculating the American Opportunity Tax Credit and the Lifetime Learning Credit.

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

The JCT estimated that the provision would decrease revenues by approximately $1.9 billion over 10 years.

**Repeal of denial of American Opportunity Tax Credit on basis of felony drug conviction**

The proposal would repeal the prohibition that excludes students convicted of a federal or state felony offense relating to the possession or distribution of a controlled substance from qualifying for the American Opportunity Tax Credit.

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

The JCT estimated that the provision would decrease revenues by approximately $180 million over 10 years.
Drug pricing

Drug price negotiation program and excise tax

The proposal directs the Secretary of Health and Human Services to establish a Fair Price Negotiation Program, to reduce the cost of selected drugs that lack price competition. Under the program, the Secretary and drug manufacturers enter into agreements and negotiate a “maximum fair price” for the selected drugs in accordance with specified methodology. Manufacturers, producers and importers that do not comply would be subject to a nondeductible excise tax on sales of the selected drugs during periods of noncompliance. The program is proposed to begin in 2025.

KPMG observation

The proposed drug price negotiation program does not modify or replace the annual fee on branded prescription drugs enacted by the Patient Protection and Affordable Care Act.

Previously approved retirement savings proposals

Automatic contribution plans and arrangements

The proposal would require employers without an employer-sponsored retirement plan to auto enroll employees in either an IRA or deferral-only 401(k) plan. These arrangements would provide for automatic contributions starting at 6% and increasing 1% every year until reaching 10%. Employees may make an affirmative election not to contribute or to modify the contribution level. The proposed requirement would not apply to the following:

- Employers with five or fewer employees
- Government employers
- Church employers
- Any employer that has been in existence for fewer than two years

The penalty for not maintaining such a plan or arrangement would be $10 per day per employee (adjusted for inflation), not to exceed $500,000 per year.

The proposed effective date is for plan years beginning after December 31, 2022.

The JCT estimated that the provision would decrease revenues by approximately $22.7 billion over 10 years.
Increase in credit limitation for small employer pension plan start-up costs including for automatic contribution plan or arrangement

The proposal would expand section 45E’s credit for small employer pension start-up costs. The proposal would increase the eligible credit period from three years to five years. In addition, the credit would be expanded for employers with 25 or fewer employees to 100% of start-up costs up to a maximum of $5,000.

The proposed effective date is tax years beginning after December 31, 2021.

The JCT estimated that the provision would decrease revenues by approximately $1.1 billion over 10 years.

Credit for certain small employer automatic retirement arrangements

A new section 45U is proposed to provide small employers (100 or fewer employees) with a $500 nonrefundable tax credit for the first four years the employer maintains an automatic retirement arrangement. The credit is proposed to be effective for tax years beginning after December 31, 2021.

The JCT estimated that this provision, together with the proposal to increase the credit limitation for small employer start-up costs including for automatic contribution plans, would decrease revenues by approximately $1.1 billion over 10 years when combined.

Matching payments for elective deferral and IRA contributions by certain individuals

The proposal includes a new refundable credit of up to $500 (adjusted for inflation) paid by the Treasury into the retirement plan of an eligible individual. The credit would be 50% of the eligible individual’s contribution up to a maximum individual contribution of $1000 and would be subject to compensation limits. An eligible individual would not include individuals claimed as a dependent by another taxpayer or who are students. The credit is proposed to be effective for tax years beginning after December 31, 2024.

The JCT estimated that the provision would decrease revenues by approximately $22.9 billion over 10 years.

Deadline to fund IRA with tax refund

The proposal would provide that contributions to a taxpayer’s IRA made directly by the Treasury Department from federal tax return refunds at the election of the taxpayer would be treated as a contribution for tax year of the return, regardless of when the funds are actually paid to the IRA account. The proposal would apply to the extent the return is filed no later than the due date for filing the return (not including extensions). The proposal would be effective for tax years beginning after December 31, 2022.

The JCT estimated that the provision would have a negligible effect upon revenues over 10 years.
Interactions between Ways and Means international proposals and BEPS 2.0

In parallel with the release of the Ways and Means proposal, the administration is actively engaged in international negotiations at the OECD to reach consensus on a two-pillar approach for reforming existing international tax standards. Neither the legislative text of the Ways and Means proposal nor the section-by-section summary refers explicitly to the OECD, but some of the main international proposals intersect and coordinate with the OECD’s ongoing work.

Pillar One of the OECD initiative would provide a new taxing right to market jurisdictions that would go beyond the arm’s-length principle and permanent establishment standard. Pillar Two proposes to implement a global minimum taxation regime 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.

KPMG observation

Overview. The specific proposals in the Ways and Means draft that most directly intersect with the OECD initiative are the revisions to the GILT I and BEAT regimes, both of which relate to Pillar Two. In general, the proposed revisions, as discussed more fully below, would bring GILT I and BEAT more in line with their corresponding provisions in Pillar Two: the Income Inclusion Rule (“IIR”) and the Undertaxed Payments Rule (“UTPR”), respectively.

The GILT I proposal, including the minimum rate, is significantly more aligned with the OECD IIR than the Green Book is. In an August 4 letter to Chairman Neal, 11 Democrats, including six members of the House Ways and Means Committee, urged “a legislative approach that reflects the substance and timeline of negotiations within the OECD process.” The letter went on to say that “enacting tax increases above and beyond the final implemented OECD agreement, or getting out too far ahead of our OECD partners, would risk U.S. international competitiveness.” The GILT I proposal seems designed, in part, to address such risk by including a rate more in line with Pillar Two, retaining an (albeit reduced) exclusion for tangible property, and providing for foreign tax credit and loss carryforwards. As discussed below, however, the GILT I proposal is still harsher than the OECD IIR in some respects, and its proposed 2022 effective date remains ahead of the OECD IIR, which will not be effective until 2023 at the very earliest.

With respect to Pillar One, the Ways and Means proposal is silent. Omitting Pillar One is unsurprising, because many design details are still being negotiated at the OECD. It is perhaps for this reason that Secretary Yellen indicated in July 2021 that Pillar One was on a “slightly slower track” than Pillar Two. In fact, it is unclear when Congress will consider Pillar One or what type of legislative vehicle might facilitate its implementation in the United States. Secretary Yellen previously indicated that Pillar One may be “ready in the spring of 2022 and we’ll try to determine at that point what’s necessary for its implementation.”
Interactions with Pillar Two. In its July statement, the Inclusive Framework agreed that the minimum rate applicable for the IIR and UTPR would be at least 15%, determined on a jurisdictional basis, with a formulaic substance carve-out equal to at least 5% of payroll and tangible assets (in the five-year transition period, at least 7.5%) and potentially other exclusions. It was agreed that the IIR was the primary rule, and should be imposed under a top-down approach starting with the ultimate parent jurisdiction, with the UTPR serving as a back-stop in respect of low-tax income not picked up by an IIR. The statement provided that “consideration would be given to the conditions under which the GILTI regime will co-exist with the IIR and UTPR rules, to ensure a level playing field.”

The Inclusive Framework’s primary concern with current GILTI is that it applies a minimum rate of only 10.5% on a base that allows global blending, thus permitting the income in a high-tax jurisdiction to be blended with income in a low-tax jurisdiction, whereas the IIR and UTPR apply on a jurisdiction-by-jurisdiction basis using a minimum rate of at least 15%. The proposal would move GILTI to a jurisdiction-by-jurisdiction approach and increase the effective rate to 16.5625%, thus eliminating the Inclusive Framework’s main source of concern about a level playing field. The GILTI proposal also includes several features that are less favorable than the IIR, including a narrower substance carve-out (reduced under the proposal to a 5% return on tangible property) and a 5% foreign tax credit haircut. For all these reasons, Inclusive Framework members are more likely to accept GILTI as a qualifying IIR if the Ways and Means proposals are enacted.

Another disconnect between current GILTI and Pillar Two is that GILTI applies in so-called U.S. sandwich structures – i.e., when a non-U.S. ultimate parent owns a U.S. subsidiary, which itself owns a non-U.S. subsidiary. Under the Pillar Two top-down approach, intermediate parent jurisdictions are required to defer the application of their IIRs to the ultimate parent jurisdiction’s IIR. Thus, in a U.S. sandwich structure, the IIR would dictate that GILTI should not apply if the ultimate parent jurisdiction has adopted an IIR. The Ways and Means GILTI proposal does not adopt this approach, but it does provide regulatory authority to allow a credit against U.S. tax for foreign taxes paid in the ultimate parent jurisdiction in a U.S. sandwich structure. The other members of the Inclusive Framework will likely see this as an improvement from current GILTI.

Current BEAT also has raised significant concerns at the Inclusive Framework. Most notably, current BEAT is inconsistent with the OECD UTPR because it applies without regard to whether a payment is high-taxed, such that it would apply even if a qualifying IIR applied in respect of the same income, contrary to the priority given to IIRs over UTPRs. Furthermore, some members of the Inclusive Framework may consider current BEAT a relevant unilateral measure that would need to be withdrawn as part of a final agreement on Pillar One. The BEAT proposal addresses the fundamental issue by providing an exception for amounts subject to a sufficient level of non-U.S. tax, using the revised BEAT rates as the applicable minimum rate, and providing broad regulatory authority for determining the effective rate on the relevant amount. This regulatory authority seems sufficient for Treasury to issue regulations that effectively deactivate BEAT in respect of payments made to groups subject to an OECD IIR.

A number of coordination issues will be required between BEAT and the UTPR, however, including at the most basic level diverging revenue thresholds. 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. In contrast, the UTPR uses a €750 million (approximately $900 million) global revenue threshold. Thus, the BEAT proposal could apply to MNEs with revenue between...
$500 million and $900 million, which is inconsistent with the OECD UTPR (albeit the inconsistency would seem likely to have relevance only for a foreign-parented group that has over half of its world-wide revenue in its US group, which does not seem likely to be a common fact pattern and thus may not raise great concerns at the Inclusive Framework). Furthermore, when it applies modified BEAT would work virtually nothing like the OECD UTPR, which relies on all subsidiary jurisdictions applying a common allocation key to collect the necessary remaining top-up tax. Because modified BEAT does not use an allocation key at all, or consider other jurisdictions’ UTPR, the result would be taxation above (or potentially below) the agreed minimum rate.

Finally, the BEAT proposal appears not to have adopted a central policy objective of the administration’s SHIELD proposal in favor of a more measured approach. In the Reasons for Change section, the Green Book noted the following in respect of SHIELD: “The administration has determined that strong measures are needed to ensure that, if a Pillar Two agreement is reached, jurisdictions have an incentive to adopt the income inclusion rule.” SHIELD’s harsh treatment of payments that either are, or would be deemed to be, low-taxed seemed intended to provide that “incentive.” In contrast, the Ways and Means BEAT proposal seems more focused on removing cliff effects. This point is underlined by the diverging revenue scores of the two provisions: SHIELD ($390B over 2022-31) compared to the Ways and Means BEAT proposal ($24B over 2022-31).

KPMG observation

Interactions with Pillar One. Pillar One is entirely omitted from the proposal. This is not surprising given the amount of technical work that is still required and Secretary Yellen’s previous statements about it being on a “slower tracker” and not being ready until around “Spring 2022.” Nonetheless, not making any reference to Pillar One may lead some members of the Inclusive Framework to question whether Congress understands the package nature of the deal at the OECD on Pillars One and Two, and the direct link between U.S. implementation of Pillar One and the removal of Digital Services Taxes (DSTs).

KPMG observation

Interactions with the OECD Forum on Harmful Tax Practices. Finally, while the Ways and Means proposal to retain FDII has no connection to the OECD’s work on Pillars One and Two, the current FDII regime has raised questions at the OECD’s Forum on Harmful Tax Practices (FHTP) as a potential preferential tax regime, which have yet to be resolved. The current FDII regime has long been “under review” by the OECD FHTP. But, in August 2021, the OECD released its latest progress report that updated FDII’s status to “in the process of being eliminated” and adding “the United States has committed to abolish this regime.” These updates were likely in response to the Green Book, which proposed to repeal FDII. It may come as a surprise to some Inclusive Framework members that the Ways and Means proposal would retain FDII, without making any structural changes to its design to address potential concerns about its compatibility with BEPS Action 5. If this proposal were adopted, presumably FDII would return to “under review.”
Modifications to system of outbound taxation

Modifications to foreign tax credit limitations

Currently, a taxpayer computes its FTC limitation separately for the foreign source income in each of the four categories described in section 904(d). These categories currently include: 1) non-passive income included under section 951A (i.e., the U.S. shareholder’s GILTI inclusion), 2) foreign branch income, 3) passive category income, and 4) general category income. The proposal includes several modifications to the application of the FTC limitation to those categories.

Repeal of foreign branch category and application of country-by-country FTC limitation

The proposal would eliminate the separate category for foreign branch income, thereby reducing the number of categories in section 904(d) from four to three. The proposal would also require the FTC limitation for each separate category to be computed on a country-by-country basis with income assigned to a country based on the residence of the taxable unit that earns the income. For this purpose, the proposal defines a taxable unit to include: 1) the U.S. taxpayer, 2) a controlled foreign corporation of which the taxpayer is a U.S. shareholder, 3) an interest in a pass-through entity owned by a U.S. shareholder or a controlled foreign corporation that is a tax resident in a foreign country, and 4) a branch of the U.S. taxpayer or a CFC that has a taxable presence in a foreign country. The income earned within each country that is attributed to a taxable unit within a separate limitation category would be combined with income of other taxable units in the same country for purposes of calculating the taxpayer’s FTC limitation within such country-by-country separate limitation category.

The proposal provides several specific grants of regulatory authority. First, Treasury would be granted authority to issue regulations that assign items (including foreign taxes and deductions, as well as amounts not otherwise taken into account in determining taxable income for U.S. tax purposes) to taxable units. Second, because the proposals would assign items to “exactly one taxable unit of the taxpayer,” coordination rules would be necessary to assign items to entities, arrangements, and branches that are considered resident in more than one country or no country. Finally, Treasury would be granted regulatory authority to provide guidance on the application of the proposals to hybrid entities or transactions (both within the meaning of section 267A), pass-through entities, passive foreign investment companies, trusts, and other entities or arrangements not otherwise described by the proposals.

KPMG observation

The proposal generally applies the country-by-country approach to prevent cross-crediting “high” and “low” tax income within a separate limitation category. While the Green Book would limit its country-by-country approach to the GILTI and foreign branch categories, the proposal would extend country-by-country separate limitation categories to all section 904(d) categories (after repeal of the foreign branch limitation category). Under current law, in order for income to fall within the foreign branch category, it generally must be earned in connection with the conduct of a foreign trade or business of a U.S. taxpayer; otherwise, non-passive income of a U.S. taxpayer generally falls within the general category. By applying the country-by-country approach to each separate category, the proposal goes beyond the Green Book and subjects income earned by a U.S. taxpayer through a disregarded entity that is a tax resident of a given country (or a branch that gives rise to a taxable presence in such country) to the country-by-country limitation even if the activities in such country are not substantial enough to constitute a trade or business. In contrast, the Wyden Proposal would prevent cross-crediting through a mandatory high-tax exception regime for subpart F and the GILTI and foreign branch limitation categories.
KPMG observation

In order for the activities of a branch to constitute a taxable unit of a taxpayer, such activities need only give rise to a taxable presence in a foreign country under the proposal. The taxable presence standard that is used to determine whether U.S. taxpayer has a one or more separate taxable units would often be a lower threshold than the definition of foreign branch under current law, which requires that the activities rise to the level of a trade or business. By eliminating the foreign branch category and adopting a taxable unit standard, the proposal effectively groups income of a U.S. taxpayer that is currently general limitation category with income of that U.S. taxpayer that is currently foreign branch category where the income is subject to net income tax in a particular foreign country on the basis of residence or presence. The impact of this change is that non-passive income that the U.S. tax system attributes to a U.S. taxpayer’s taxable unit within a particular foreign country would often more closely align with the foreign tax base and would generally be subject to a single foreign tax credit limitation.

KPMG observation

The expected application of the proposal’s country-by-country regime can be illustrated with the following example. USP owns two CFCs (one organized in Country X and one organized in Country Y) and a DRE organized within Country X. The CFCs and the DRE each earn only general limitation income and operate only in the countries where they are organized. The general limitation income earned by the CFCs is included by USP as subpart F income. Under the proposals, USP would compute its FTC limitation within the general limitation category on a country-by-country basis, and USP, CFC X, CFC Y, and DRE would each be treated as a separate taxable unit. Thus, USP would combine its subpart F income from the CFC organized in Country X with its income earned for U.S. federal income tax purposes through DRE also organized in Country X in a single general limitation Country X category for purposes of computing its 904(a) limitation. USP’s general limitation for Country Y would be separately computed and would include only the subpart F income from the CFC organized in Country Y.

KPMG observation

The proposal would grant Treasury the authority to prescribe regulations for assigning items of income, deduction, and foreign taxes to a taxable unit, including items not otherwise taken into account in determining taxable income for U.S. tax purposes. An important area for which guidance would be needed is in the case of disregarded payments between separate taxable units. It seems likely that Treasury would leverage the current approaches adopted or proposed in various current final and proposed regulations for addressing such disregarded transactions under the specific regulatory authority granted by the proposal. To date, Treasury has issued a myriad of final and proposed rules for assigning income, deductions, and foreign income taxes related to disregarded payments. While those regulations generally operate starting from a similar set of basic rules and concepts, there are notable differences between the rules as they have been further refined to apply in different contexts (as well as generally having been written and adopted at slightly different times since the enactment of TCJA). For example, a disregarded interest payment is not considered when applying the regulations for purposes of determining foreign branch category income. However, disregarded interest payments are considered by the final GILTI high-tax
exclusion regulations to the extent deductible under foreign law by the payor. Further, the interest expense allocation rules under final regulations would allocate and apportion third party interest expense of a U.S. shareholder or CFC based on all of the assets of such U.S. shareholder or CFC, respectively. In contrast, the proposed GILTI high-tax exclusion regulations would allocate and apportion third party interest expense by applying a "booking rule." The approach under the proposed GILTI high-tax exclusion regulations would result in the U.S. income and expense items more closely aligning with the foreign tax base. Finally, the final and proposed GILTI high-tax exclusion regulations contain different ordering principles when multiple disregarded payments are made between units of a single taxpayer than those that apply in determining foreign branch category income.

The difference between the current rule for allocating interest expense and the booking rule for purposes of the GILTI high-tax exclusion can be illustrated by the following example. USP owns a CFC organized in Country X that owns DRE X and DRE Y. CFC has no income, assets, or operations. DRE X and DRE Y each earn $100 of tested income and own tested income-producing assets with a tax book value of $500. DRE Y has $20 of third-party interest expense that is deductible for Country Y tax purposes. Under the current rules for allocating and apportioning interest expense, DRE Y’s interest expense would be allocated equally against DRE X’s and DRE Y’s tested income for U.S. federal income tax purposes. However, for Country X and Country Y purposes, all $20 of interest expense would be allocated against the Country Y tested income. The booking approach from the proposed GILTI high-tax exclusion regulations would allocate all $20 of interest expense to the Country Y tested income resulting in a closer alignment of the U.S. income and foreign tax base.

Treating disregarded interest payments that are deductible in the foreign jurisdiction as giving rise to a reallocation of income between taxable units and including a “booking rule” similar to such rule in the current proposed GILTI high tax exclusion regulations would appear to better align the foreign taxable base with the U.S. federal income tax computation of the country-by-country limitations. Finally, adoption of ordering principles similar to those contained in the GILTI high-tax exclusion regulations would be necessary as a given taxpayer may have more than one other taxable unit making or receiving disregarded payments, and the ordering rules contained in the foreign branch category regulations are suited for allocating income of a given taxpayer between two groupings (i.e., the general category and the foreign branch category).

KPMG observation

This proposal diverges from the approaches taken in the Green Book and the Wyden Proposal, each of which would have retained the category for foreign branch income. However, the separate country approach to the FTC limitation would generally achieve similar results by separating high-taxed and low-taxed income earned by a U.S. taxpayer.

Consider the following example: USP operates through a foreign branch in Country X and a CFC organized in Country X. During the tax year, USP earns high-taxed income in Country X through the foreign branch and low-taxed royalty income from the CFC, each of which is not passive category income. The proposal would treat each of USP, USP’s Country X branch, and CFC as a separate taxable unit. Further, the elimination of the foreign branch income category would result in the income from the Country X branch and the royalty income being grouped within the general category. However, each of these items is expected to be attributed to a separate taxable unit — the high-taxed branch income to USP’s Country X branch and the royalty to USP. As a result, USP could not blend the high-taxed Country X income with the low-taxed royalty income from CFC.
The proposal would, however, allow the blending of high-taxed income and low-taxed income to a limited extent. For example, under the proposal, a taxpayer may blend high-taxed income earned through a foreign branch taxable unit with low-taxed general category subpart F income earned through a CFC taxable unit provided such amounts are subject to tax by the same country. However, the instances in which a taxpayer would earn general subpart F income would be significantly diminished with the proposal’s modification of the definition of related party that applies for purposes of determining both foreign base company sales and foreign base company services income, discussed separately in this report. Additionally, if, in the example in the preceding paragraph, USP earned the royalty through a DRE that is tax resident in Country X, the royalty income of the DRE and Country X branch would be subject to a single limitation. However, such grouping may be of limited value when the same rate of tax in Country X applies to both sets of income and there are no timing differences in respect of Country X income or deductions. The same blending would not occur under current law or the Green Book or Wyden Proposal, which would have segregated the high-taxed foreign branch income within a separate category from other general category income of the taxpayer.

KPMG observation

A country-by-country approach to the FTC limitation would increase compliance burdens for taxpayers with foreign source income earned in multiple countries. Taxpayers are required to file a separate Form 1118 for each FTC limitation basket. Because each country in which a taxpayer earns foreign source income and pays or is deemed to pay foreign taxes would create a separate FTC limitation basket, the number of Form 1118s to be filed for many U.S. multinational companies would increase significantly.

Treatment of certain tax-exempt dividends / allocation of deductions to GILTI

In determining the amount of income within both the numerator and denominator of the FTC limitation, a taxpayer must currently make certain adjustments that are described in section 904(b)(4). In particular, the taxpayer does not take into account 1) any dividends that are eligible for the section 245A dividends received deduction (“section 245A dividends”), and 2) any deductions that were allocated to section 245A dividends (including the section 245A deduction itself) or stock in a foreign corporation that may produce section 245A dividends (“section 245A stock”). These adjustments are made to the denominator of the FTC limitation when calculating the FTC limitation for all categories, as well as the numerator for a particular category when the section 245A dividends or the associated apportioned deductions are within such category (generally, the general category).

The proposal would modify the approach for addressing section 245A dividends or section 245A stock by treating such income and assets as tax-exempt under section 864(e)(3). Further, the current rule in section 904(b)(4) would be replaced with a new rule that would limit the deductions of a U.S. shareholder allocable to income within the GILTI category to only the section 250 deduction for purposes of computing the GILTI country-by-country separate limitations.

KPMG observation

By limiting the U.S. shareholder level expenses allocable to GILTI to only the GILTI section 250 deduction, this proposal would reduce the instances in which a U.S. taxpayer would incur residual
U.S. tax on a GILTI inclusion when foreign tax is paid at a rate equal to approximately 17.43% (equal to the amount of foreign tax necessary to offset U.S. tax at an effective rate of 16.5625% taking into account the section 250 deduction and a 5% haircut on such foreign taxes). In prior comment letters, taxpayers had requested that Treasury provide this result through regulations given that the TCJA legislative history to the GILTI regime explicitly stated in a footnote that U.S. taxpayers would not pay residual U.S. tax on a GILTI inclusion when the foreign jurisdiction taxed such income at a rate equal to 13.125%.

KPMG observation

The proposal includes section 163(n), which, as discussed separately in this report, would limit a taxpayer’s interest expense deduction when its U.S. operations are overleveraged in comparison to its foreign operations, including those conducted through CFCs. Presumably because of this disallowance, the proposal would not allocate and apportion interest to the GILTI category, but only for purposes of determining the income within the GILTI category for section 904 purposes. The proposal does not include any other rules to coordinate the implications of proposed section 163(n), which, if enacted in its current form, should obviate the policy rationale for apportioning any interest expense to income from CFCs. Nonetheless, the proposal does not address, for example, the allocation and apportionment of interest expense to income earned by a CFC that is in the general or passive limitation categories (e.g., subpart F income).

More granularly, the proposal does not address how CFC stock value should be taken into account for purposes of apportioning interest expense in light of both the disallowance of interest deductions by reference to CFC earnings and the limited provision that turns off interest allocation to GILTI solely for purposes of determining GILTI category income. Currently, the value of first tier CFC stock is computed under regulations and such value is characterized based upon the modified gross income or asset method. If a first tier CFC earns gross tested income and its U.S. shareholder has a positive inclusion percentage, then a portion of the first tier CFC stock would be characterized as within the GILTI limitation category. Absent the proposal’s special rule generally turning off expense allocation to GILTI, that characterization would result in at least a portion of the U.S. shareholder’s interest expense being apportioned to the GILTI limitation category. Because the apportionment of stewardship expense is based on the same asset method, a portion of the U.S. shareholder’s stewardship expense would also be apportioned to the GILTI limitation category.

How such stock value should be taken into account for purposes of apportioning interest and stewardship expense appears unresolved given that the proposal does not include a specific proposal to eliminate the value of CFC stock for purposes of interest expense or stewardship apportionment and, as noted above, provides that only the section 250 deduction attributable to a GILTI inclusion in a country-by-country separate limitation category is apportioned to such category. Thus, absent other changes and given that the expense allocation proposal related to GILTI only applies for purposes of computing GILTI category income for section 904 purposes, the proposal suggests that interest expense and stewardship are allocated and apportioned to the GILTI category for purposes of determining the portion of interest expense and stewardship that is apportioned to the other separate limitation categories and U.S. source income. Absent this, income within the general and passive limitation categories would be overburdened by stewardship deductions if the asset method is retained. Nonetheless, with respect to interest, there is a strong argument for eliminating the CFC stock from the apportionment altogether if proposed section 163(n) is enacted.
Proposed section 163(n) can be contrasted with the approach taken in the Green Book, which would have relied on existing concepts to allocate interest and other deductions and expanded section 265 to deny deductions for expenses that are allocated to partially tax-exempt income (e.g., GILTI inclusions eligible for the section 250 deduction) or section 245A-eligible dividends.

**Modification of FTC carryover period**

Under current law, a taxpayer that accrues, pays, or is deemed to pay foreign taxes in excess of its FTC limitation within a separate category may carry back such “excess credits” one year and then forward in each of the ten succeeding years in that order under section 904(c). However, a taxpayer is not entitled to carry back or forward foreign income taxes that are within the GILTI category (i.e., the taxpayer must “use or lose” currently such foreign taxes).

The proposal would, on the one hand, significantly narrow section 904(c) by eliminating the carryback period and reducing the carryforward period from 10 to five years. On the other hand, the proposal would expand section 904(c) by allowing a taxpayer to apply the five-year carryforward to excess FTCs within the GILTI basket.

**KPMG observation**

Differences between U.S. and foreign law regarding when items of income and expense are recognized are common. Applying the foreign tax credit limitation for each limitation category on a country-by-country basis would exacerbate the economic effects of timing differences, in particular with respect to the GILTI basket under the current annual approach that precludes carryovers for any losses or FTCs. The proposal to allow for the carryforward of FTCs within the GILTI basket, together with the proposals to allow tested losses to be carried forward and for foreign income taxes of tested loss CFCs to be deemed paid provided such tested losses do not exceed the tested income of other CFC taxable units that are organized within the same country, would over time better align U.S. federal income tax with the economic results of a CFC’s operations within a foreign country.

**KPMG observation**

The proposal’s modification to the carryover period would be the most restrictive since its inception. The carryover period was first introduced in 1957 as a two-year carryback and five-year carryforward period, which remained relatively constant until it was expanded in 2004 to the current one-year carryback and 10-year carryforward period.

**Modification to overall foreign loss and separate limitation loss rules**

Current section 904(f) and the regulations thereunder address instances in which a taxpayer has a loss in a separate section 904(d) category. Under these rules, if a taxpayer has a separate limitation loss (“SLL”) within an income category, the taxpayer is generally required to proportionately reduce its separate limitation income (“SLI”) within other income categories. To the extent that the taxpayer’s loss exceeds its SLI within all income categories in the tax year, the remaining amount constitutes an overall foreign loss (“OFL”) that reduces the U.S. source income of the taxpayer.

Losses must be recaptured in a future tax year in which the taxpayer has SLI within the same income
category as the prior year loss that offset SLI in another income category or resulted in an OFL under current regulations. Reg. § 1.904(g)-3 provides specific ordering rules regarding the recapture of SLLs and OFLs and requires that the taxpayer recapture the SLI first as U.S. source income to recapture the OFL and then recapture any remaining amount as SLI in the income category that was offset in the prior tax year. (Conversely, if a taxpayer has an overall domestic loss (“ODL”), future U.S. source income is recaptured as foreign source income in the category offset by the ODL pursuant to generally reciprocal rules.)

The proposal would modify the current rules applicable to SLLs by expanding the definition of income category to apply on a separate country-by-country basis within each income category. The proposal would also provide that the taxpayer must first allocate its SLL to offset SLI in each income category other than GILTI before allocating any amount to its SLI within the GILTI category.

**KPMG observation**

The proposal’s expanded definition of income category appears to treat each separate country within a section 904(d) category as its own separate limitation category for purposes of future SLL or OFL recapture. This change would significantly narrow the instances in which OFL recapture may occur in a future tax year. For example, a taxpayer with an OFL related to the general category for Country X would only recapture such OFL when general category Country X income is earned in the future and not for general category income associated with any other country.

**KPMG observation**

The proposal’s adoption of a country-by-country regime and the repeal of the foreign branch income category would result in the need for transition rules to address SLL, OFL, and ODL accounts and FTC and NOL carryforwards that arose in tax years prior to a tax year in which the proposal took effect. When this same issue arose in the context of the TCJA, Treasury addressed such transition issues by providing guidance in regulations.

**KPMG observation**

The combination of rules in the proposal related to GILTI losses and foreign taxes, including the priority rule for allocating SLLs first to non-GILTI category income and the carryforward period for GILTI FTCs, would mitigate the harsh result of losing GILTI FTCs that can often occur under current law.

The effective date for each of these proposals related to the FTC limitation would be for tax years beginning after December 31, 2021.

**Changes to the timing for claiming a deduction or credit for foreign income taxes**

The proposal would revise several provisions of the Code related to the timeframe for claiming a foreign tax credit or deducting foreign income taxes. First, the proposal would amend section 905(c)(1) to add two additional events that would give rise to a foreign tax redetermination for which a redetermination of U.S. tax liability is generally required: (i) a change to the taxpayer’s election to claim a credit or a deduction for foreign income taxes and (ii) any other change in the amount or treatment of foreign
income taxes when that change affects the taxpayer’s U.S. federal income tax liability.

**KPMG observation**

The changes to section 905(c) appear consistent with proposed regulations issued on November 12, 2020 (85 Fed. Reg. 72078) (the “2020 Proposed Regulations”) that would revise the definition of a foreign tax redetermination in Reg. § 1.905-3. The preamble to those proposed regulations laid out an extensive case for the inclusion of those revisions based on current law. The changes to section 905(c)(1) introduced by the proposal would codify those proposed regulatory changes.

The proposal would also change the time period during which a taxpayer may change its choice between deducting or crediting foreign income taxes. Under the proposal, section 901(a) would be amended to allow a taxpayer to elect to claim a foreign tax credit within the special limitation period provided by section 6511(d)(3)(A) (currently 10 years but revised to five years by the proposals) and to elect to claim a deduction for foreign income taxes within the general limitation period provided for refund claims (three years under section 6511(a) and subject to extension by agreement under section 6511(c), the “general refund period”). Section 6511(d)(3)(A) would also be revised to provide that the extended period of limitation for a refund only applies when the refund relates to an overpayment attributable to a “change in the liability for” foreign income taxes paid or accrued.

**KPMG observation**

The proposal’s changes to the timeframe for a taxpayer to decide whether to claim a deduction or a credit for foreign income taxes is consistent with proposed revisions to Reg. § 1.901-1(d) described in the 2020 Proposed Regulations. If enacted, taxpayers may find it preferable to initially deduct foreign income taxes paid in a tax year that would otherwise be added to a section 904(c) carryforward if, at such time, the taxpayer is uncertain that such section 904(c) amount could be used as a credit in a future tax year. Taxpayers doing so would then have five years (based on section 6511(d)(3)(A) as revised by the proposal) to change from a deduction to a credit, whereas a taxpayer initially electing to credit taxes may have only three years (based on section 6511(a)) to change from a credit to a deduction. However, as noted immediately below, if a taxpayer elects to credit foreign taxes after the general refund period has expired, such taxpayer may not be eligible to receive all or part of any refund that would otherwise result from its amended election to credit foreign taxes.

**KPMG observation**

Although section 901(a) would allow a taxpayer to change its election from deduction to credit within the five-year period provided by section 6511(d)(3)(A), section 6511(d)(3)(A), as revised, would only extend the period of limitation for a refund to five years if the refund relates to an overpayment attributable to a “change in the liability for” foreign income taxes paid or accrued. The general three-year period of limitation for refunds in section 6511(a) would apply absent a change in foreign income tax liability. Thus, taxpayers who initially elect to deduct foreign income taxes in a tax year would apparently need to file an amended return to elect to claim a foreign tax credit for such tax year within the three-year period of limitation for refunds in order to claim a refund in such tax year if the taxpayer’s liability for foreign income taxes had not changed. This change to section 6511(d)(3)(A) effectively aligns the period of limitations for refunds related to the deduction and
credit for foreign income taxes paid in a tax year absent a change in the amount of the taxpayer’s foreign income tax liability for such tax year. Further, it is not clear to what extent a refund would be considered to relate to an overpayment attributable to a “change in the liability for” foreign income taxes paid or accrued. For example, if a taxpayer initially elects to deduct foreign taxes it paid to country X and country Y and then elects to change to credit such foreign taxes upon settling an audit with country X after the general refund period has expired, query whether the taxpayer is entitled to receive a refund only for the overpayment attributable to the country X taxes where its country Y tax liability has remained unchanged.

KPMG observation
The proposal to reduce the section 6511(d)(3)(A) limitation period for filing a claim for refund with respect to foreign tax credits from 10 years to five years could severely limit taxpayers’ ability to claim foreign tax credits for foreign income taxes imposed as the result of foreign tax audits or tax contests. The shortening of such period also appears particularly harsh given that at least one court has effectively held that the IRS has an unlimited period of time to collect U.S. tax increases due to refunds of foreign income taxes that were claimed as a credit. The proposal refers to this change as a “conforming amendment” to the proposed change to reduce the foreign tax credit carryover under section 904(c) from 10 years to five years. However, it is not at all clear why the statute of limitations for claiming foreign tax credits should be conformed to the section 904(c) period for carrying forward excess foreign taxes.

The proposal would revise section 6511(d)(3)(A) to provide that the proposed five-year limitation period for filing a claim for refund attributable to a foreign tax credit begins from the date prescribed by law for filing the return for the tax year in which foreign income taxes were paid, accrued, or deemed paid pursuant to section 960.

KPMG observation
Current section 6511(d)(3)(A) uses the phrase “actually paid or accrued” to identify the tax year with reference to which the filing deadline begins. Such phrase is imprecise, especially in the case of foreign income taxes deemed paid by a taxpayer pursuant to section 960 and taxes arising from the settlement of a contest that “relate back” to an earlier tax year. The proposal would eliminate the “actually” language and clarify that the limitation period for claiming a refund attributable to foreign tax credits runs from the statutory due date for the tax return for the tax year in which such taxes are paid, accrued, or deemed paid.

Covered asset dispositions
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 controlled foreign corporation, 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 proposal, to be enacted as new section 904(b)(5), would apply the principals of section 338(h)(16) to any “covered asset dispositions.” For these purposes, a covered asset disposition means a transaction that is treated as a disposition of assets for purposes of the Code’s foreign income provisions (Subchapter N) but is treated as a disposition of stock of a corporation (or is disregarded) for purposes of the tax laws of the relevant foreign country or possession.

KPMG observation

The definition of a “covered asset disposition” mirrors the section 901(m)(2)(B) definition of a “covered asset acquisition,” and the close nomenclature reinforces that the proposal is intended to similarly curtail foreign tax status arbitrage benefits on the seller (disposer) side.

Accordingly, for purposes of certain international provisions, the source and character (but not the amount) of any item resulting from a covered asset disposition 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 includes a grant of regulatory authority to carry out the purposes of the new rule, including to prevent the avoidance of the purposes of the rule.

The proposal would apply to tax years beginning after December 31, 2021.

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 covered asset dispositions, the proposal similarly would result in items of income or loss originating from a transaction that may avoid tax in the local jurisdiction being treated as a sale of stock for foreign tax credit purposes. This treatment would generally result in U.S. source passive income for a U.S. seller, or foreign source passive income for a CFC seller. Because, however, the application of section 338(h)(16) is limited to the foreign tax credit rules (sections 901-909), it appears that the proposal would not affect the status of a CFC seller’s gain from a covered asset disposition as section 951A tested income versus section 951(a) subpart F income.

The proposal is similar to, and presumably drawn from, earlier proposals by the Obama Administration in the FY 2013-2017 Green Books, in Senator Baucus’s 2013 tax reform package, and the Biden Administration’s FY 2021-2022 Green Book. The current proposal refers to the scope of provisions that would be impacted as “this part,” which would extend beyond foreign tax credit rules to include the subpart F and GILTI rules. However, the continued use of the phrase “source and character,” the failure to make any reference to subpart F and GILTI (although that would be a significant expansion beyond the scope of section 338(h)(16)), and the fact that the Joint Committee on Taxation’s description of the proposal uses the word “subpart” in describing the scope of the provision all suggest that the intent is to have a similar scope to the prior proposals.
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.

Modifications to inclusion of global intangible low-taxed income

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 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. The 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 that may be repatriated to a 10% corporate U.S. shareholder without being subject to U.S. tax if the corporate shareholder qualifies for a DRD under section 245A.

Country-by-country application

The proposal would require U.S. shareholders to compute their GILTI inclusion and associated foreign tax credit on a country-by-country basis. To achieve this result, the proposal would aggregate the tested income, tested loss, net deemed tangible income return and foreign taxes that are attributable to the U.S. shareholder’s CFC taxable units within the same country. The proposal would generally import the taxable unit standard from the proposed FTC limitation rules described above. Under the proposal, CFC taxable units include (1) CFCs themselves; (2) each interest directly or indirectly held by the CFC in a passthrough entity if the CFC and the passthrough entity are not tax residents of the same foreign country; and (3) activities that are directly or indirectly carried on by the CFC giving rise to a taxable presence in a country other than the country in which the CFC is a tax resident (i.e., a branch). The proposal would apply to tax years of foreign corporations beginning after December 31, 2021, and to tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

KPMG observation

The proposal’s country-by-country approach for determining GILTI would prevent tested losses incurred in one country from reducing tested income earned in another country. Consequently, taxpayers would benefit currently from a tested loss incurred within a particular country only to the extent a taxable unit elsewhere in the structure has offsetting tested income earned within the same country. However, the proposal allowing for the carryforward of tested losses (discussed below) is expected to mitigate this adverse impact to U.S. shareholders. Nevertheless, if a taxpayer
owns a CFC that has a taxable unit operating at a tested loss in a country, such taxpayer may be unable to repatriate previously taxed E&P (“PTEP”) resulting from the tested income of a taxable unit of the same CFC in a different country where the tested loss causes the CFC’s total E&P to be below the amount of the taxpayer’s PTEP.

The proposal could also significantly increase the amount of PTEP baskets. This could increase reporting complexities (e.g., Form 5471 Schedules E-1 and P would require more effort to complete) and other administrative complexities that may make it more difficult to repatriate foreign earnings to the United States. Current law already provides 10 PTEP categories for taxpayers to track and maintain, and a separate jurisdiction-by-jurisdiction approach would significantly increase the amount of PTEP categories. Additionally, there would likely be a substantial increase in the amount of excess limitation accounts to track under section 960(c) with a country-by-country regime. One of the TCJA’s principal goals 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 the complexity and uncertainty with respect to the rules regarding PTEP distributions. A country-by-country regime may further exacerbate those difficulties.

** Carryover of net CFC tested loss

Under current law, tested losses of one CFC may be used to fully offset tested income of another CFC, resulting in no GILTI inclusion with respect to a U.S. shareholder. However, if tested losses in a tax year exceed tested income in the same year, the excess may not be carried over to any other tax year under current law.

Under the proposal’s country-by-country approach, tested losses of a CFC taxable unit in one country would only be permitted to offset tested income with respect to that same country. The proposal also would introduce a new rule providing that a U.S. shareholder may carry over its net tested loss for a tax year (which would reflect any carryover of a tested loss from a prior year) with respect to a particular country to the following tax year, increasing tested loss for that country in the subsequent tax year. To the extent that the tested loss does not fully offset tested income of the U.S. shareholder in that subsequent year, the unused portion would continue to be carried forward. The proposed tested loss carryforward rule would require that appropriate adjustments be made in the allocation of GILTI to CFCs to take into account a decrease in a U.S. shareholder’s GILTI inclusion as a result of the use of a tested loss carryforward. The proposal would apply to tax years of foreign corporations beginning after December 31, 2021, and to tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

** KPMG observation

The disallowance of net CFC tested loss carryovers under current law can result in mismatches between the foreign and U.S. federal income tax treatment for purposes of determining taxable income, particularly where, as is generally the case, the foreign jurisdiction provides for loss carryovers. For example, if Country X CFC incurs a ($50) tested loss in Year 1, earns $100 of tested income in Year 2, and is permitted to carryover the Year 1 loss to offset Year 2 income for Country X tax purposes but not for GILTI purposes, CFC X would have $50 of taxable income in Year 2 for foreign purposes, but tested income of $100 for U.S. purposes. The proposed net CFC tested loss carryover rule provides some relief by creating some degree of parity between U.S. and foreign law in such circumstances, which is complemented by the proposed rule allowing for GILTI foreign tax
credit carryforwards.

The proposal provides that tested losses may be carried forward by a U.S. shareholder to the succeeding tax year but does not provide for carrying any CFC tested loss back to tax years before the loss was incurred. For example, assume a U.S. shareholder’s wholly owned Country X CFC earns $100 of tested income in Year 1 and incurs a ($150) tested loss in Year 2. In Year 1, U.S. shareholder had a GILTI inclusion with respect to CFC’s Year 1 tested income and claimed a credit for foreign taxes properly attributable to that tested income. For Country X purposes, CFC carries the Year 2 loss back to Year 1 and claims a refund with respect to Country X taxes paid. Although it seems that U.S. shareholder would be subject to the foreign tax redetermination rules as a result of the refund of Year 1 Country X taxes, CFC would not be able to carry back any portion of the Year 2 tested loss to offset Year 1 tested income and reduce U.S. shareholder’s Year 1 GILTI inclusion.

KPMG observation

The appropriate adjustments described by the proposal may include reductions in the basis of tested loss CFCs to account for the economic loss of such CFC that was used to reduce the amount of a U.S. shareholder’s GILTI inclusion from another CFC within the same country, similar to the adjustments provided by section 965 when specified deficits were used to offset the earnings and profits of a deferred foreign income corporation.

The proposal also includes a conforming amendment to section 382(d) to account for net CFC tested loss carryforwards in determining the extent to which losses incurred by a corporation prior to a change in ownership are potentially disallowed under the section 382 loss limitation rules. Specifically, the proposal would expand the definition of “pre-change losses” to include a U.S. shareholder’s net CFC tested loss carryforwards. Notably, the net CFC tested loss carryforward would not be a CFC attribute but instead would be a shareholder-level attribute that could be used to reduce a U.S. shareholder’s future GILTI inclusions with respect to the relevant country. As such, the proposal may permit a U.S. shareholder’s pro rata share of a net tested loss of a taxable unit of a CFC to reduce the U.S. shareholder’s GILTI inclusion with respect to that same country in a future year even if the U.S. shareholder no longer owns the taxable unit in which the tested loss arose. The proposal would apply to tax years beginning after December 31, 2021.

Reduction in net deemed tangible income return

The proposal would amend the calculation of net deemed tangible income return by decreasing the deemed return on a CFC’s QBAI from 10% to 5% (except in the case of assets located in U.S. territories). The proposal would apply to tax years of foreign corporations beginning after December 31, 2021, and to tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

KPMG observation

The Green Book advocates for eliminating the net deemed tangible income return as providing a “perverse” incentive for U.S. multinationals to invest in tangible assets abroad. Somewhat surprisingly, the Ways and Means proposal preserves the concept, but cuts in half the deemed return on QBAI. One explanation for QBAI’s survival may be that the drafters were seeking some
alignment with Pillar 2, which as mentioned above, currently includes at least a 7.5% return on payroll and tangible assets, with an expectation that it will eventually phase down to 5%.

The JCT has estimated that the proposal would raise approximately $106.726 billion over a 10-year period.

**Modifications to determination of deemed paid credit for taxes properly attributable to tested income**

**Increase in deemed paid credit**

Current section 960(d)(1) provides that 80% of the foreign income taxes attributable to tested income includible in a corporate U.S. shareholder’s gross income as a section 951A inclusion are deemed paid by such shareholder. The 20% “haircut” to the amount of such foreign income taxes deemed paid reduces the amount of foreign income taxes attributable to tested income that may be claimed as a foreign tax credit within the section 951A limitation category. The proposal would reduce that haircut to 5%, increasing the percentage of tested foreign income taxes that are creditable. The proposal would apply to tax years of foreign corporations beginning after December 31, 2021, and to tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

**KPMG observation**

The U.S. tax rate on GILTI inclusions for corporate U.S. shareholders under the proposal would be 16.5625% (26.5% top corporate rate x (100% - 37.5% deduction)). When combined with a 5% haircut on foreign income taxes and the section 78 gross-up, a CFC would need to pay foreign income taxes on tested income at an effective rate of nearly 17.5% to eliminate any residual U.S. tax on the U.S. shareholder’s GILTI inclusion. The legislative history to the TCJA illustrated that there should be no U.S. residual tax under the current GILTI regime for earnings subject to a foreign effective tax rate of 13.125% (21% top corporate rate x (100% - 50% deduction) / 80%), which proved to be incorrect because it did not account for expense allocation to the GILTI basket at the U.S. shareholder level. In contrast, in light of the proposal’s amendment to section 904(b)(4) to eliminate the allocation of expenses (other than the section 250 deduction) to the GILTI basket, it appears that no residual U.S. tax would be imposed on separate country GILTI inclusions when the underlying tested income is subject to at least a 17.5% effective tax rate.

However, in order for no residual U.S. tax to result, the allocation and apportionment of deductions for U.S. tax purposes at the level of the CFC owning the taxable unit must be consistent with the deductions taken into account by the local jurisdiction in which the taxable unit is resident. For example, if a taxable unit has third party interest expense of $100, all of which is deductible in determining its foreign tax liability, residual U.S. tax may result if the $100 interest expense is allocated in whole or in part to other taxable units of the CFC under existing interest expense allocation and apportionment rules (e.g., the modified gross income or asset methods).

**Inclusion of taxes properly attributable to tested losses**

Under current section 960(d), a corporate U.S. shareholder can claim a credit for “tested foreign income taxes” attributable to tested income included by the U.S. shareholder in income under section 951A. Under current regulations, tested foreign income taxes excludes foreign income taxes associated with a tested loss, precluding a U.S. shareholder from claiming a deemed paid credit for such taxes. The
The proposal would amend section 960(d)(3) to expand the definition of “tested foreign income taxes” to include taxes attributable to tested losses. This proposal would apply to tax years of foreign corporations beginning after December 31, 2021, and to tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

**KPMG observation**

Under section 960(d)(1), which would not be amended by the proposal, a shareholder can claim deemed paid foreign tax credits for tested foreign income taxes only if it has a GILTI inclusion. Thus, while the proposal would treat foreign income taxes attributable to a tested loss as “tested foreign income taxes,” such taxes would apparently be deemed paid by a U.S. shareholder, thereby unlocking the proposed five-year carryforward for excess foreign taxes in the relevant per-country GILTI basket, only if the U.S. shareholder has an overall GILTI inclusion with respect to that country in the year the taxes are paid or accrued. As noted above, the proposal would allow U.S. shareholders to carryforward net CFC tested losses with respect to a jurisdiction to offset future tested income for that jurisdiction. In light of that relaxation of the tested loss rule and the proposal to allow carryforwards for excess GILTI FTCs, it is not clear why the proposal does not similarly allow tested foreign income taxes associated with net tested losses to be carried forward at the U.S. shareholder level.

**Credit for foreign taxes paid under an income inclusion rule**

The proposal would amend section 960(d)(3) to generally allow a foreign-parented U.S. corporate shareholder that owns CFCs to take into account foreign taxes paid by the foreign parent that are attributable to amounts of such CFCs taken into account in determining tested income or tested loss. In order for this rule to apply, the foreign parent must own, directly or indirectly, 80% or more (by vote or value) of the U.S. corporate shareholder, and the foreign parent’s taxes attributable to the tested income or tested loss must not be creditable, in whole or in part, in any foreign jurisdiction. Importantly, this rule would be effective “solely to the extent provided in regulations prescribed by the Secretary” and thus is dependent on the issuance of regulations. The proposal would apply to tax years of foreign corporations beginning after December 31, 2021, and to tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

**KPMG observation**

The proposal is generally in line with the Green Book which would allow a foreign-parented U.S. group that owned CFCs to take into account foreign income 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.” The effect of the Green Book proposal, and the current House proposal would be to allow foreign income taxes paid pursuant to an IIR to reduce a U.S. corporate shareholder’s residual U.S. tax on GILTI. Furthermore, the House proposal makes clear that the section 960(d)(1) haircut would apply to such foreign income taxes. The Green Book made clear that only foreign income taxes paid by the ultimate foreign parent would be considered. However, the House proposal is not so explicit. For example, if FP (Country X) owns FS (Country Y) and FS 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 under the Green Book proposal, but may potentially be taken into account under the House proposal, subject to regulations prescribed by the Secretary.
Application of foreign tax credit limitation to section 78

The proposal also includes several modifications with respect to section 78. One proposal would amend section 904(d)(2) to make clear that any amount included in gross income under section 78 would be treated as income in the same separate category as the related foreign taxes deemed paid. Another proposal would amend section 78 by removing its reference to section 960(b) (allowing foreign income taxes paid by a CFC that are attributable to PTEP to be deemed paid when such PTEP is distributed); without such removal, any such taxes are included in the shareholder’s gross income under section 78. Finally, a proposal would revise the look-through rules of section 904(d)(3)(G) to strike language that treats a section 78 gross-up as an inclusion under section 951(a)(1)(A) with language that merely treats the section 78 gross-up as income that is not a dividend. The proposals would apply to tax years beginning after December 31, 2017.

KPMG observation

There has been some uncertainty as to whether a section 78 gross-up resulting from a section 951A inclusion would be treated as income in the GILTI basket or would instead default to the general basket. Treasury has previously clarified that the section 78 gross up is assigned to the same category to which such taxes were allocated. See Reg. § 1.904-4(o). The proposal would codify that regulation.

KPMG observation

Prior to the TCJA, section 78 did not reference former section 960(a)(3) (which, at the time, addressed taxes deemed paid on PTEP distributions) and thus there was no section 78 gross-up for taxes deemed paid under section 960(a)(3). That non-application of section 78 is consistent with the purpose of the section 78 dividend, which is to prevent a U.S. shareholder from obtaining both a deduction and a foreign tax credit for foreign income taxes paid by a CFC. Section 78 as revised by the TCJA included a reference to section 960(b), which currently deems a corporate U.S. shareholder to pay foreign income taxes attributable to PTEP of a CFC when such PTEP is distributed. That reference results in double taxation in the amount of such section 78 gross-up because the foreign income taxes deemed paid with respect to PTEP reduced the amount of such PTEP when such taxes were paid without giving rise to a deduction. The proposal would remove the reference to section 960(b) in section 78 consistent with prior proposed technical corrections and would thereby eliminate current law section 78’s double taxation of amounts previously taxed under subpart F, GILTI, and section 956.

The JCT has estimated that the proposal would lose approximately $39.77 billion over a 10-year period.

Modifications to deduction for foreign-derived intangible income and global intangible low-taxed income

Reduced deduction

The proposal would retain the section 250 deduction for FDII and GILTI with certain modifications. However, the proposal would reduce the amount of the section 250 deduction to 21.875% of FDII (from 37.5%) and 37.5% of GILTI and the corresponding section 78 gross-up (from 50%). At the proposed highest marginal corporate tax rate of 26.5%, FDII and GILTI would be taxed at 20.7% and
16.56%, respectively. For calendar year taxpayers, these changes would be effective for tax years beginning after December 31, 2021. For fiscal year taxpayers, a blended rate would apply to the year that includes December 31, 2021, based on the portion of the tax year that precedes January 1, 2022.

**KPMG observation**

The reduction in the section 250 deduction percentage would merely accelerate the reductions that, under current law, would go into effect for tax years beginning in 2026. However, due to the proposed increase in the top corporate rate, the proposed 20.7% effective rate for FDII and the 16.56% effective rate for GILTI would still be significantly higher than would occur in 2026 under current law (16.4% for FDII, 13.125% for GILTI).

**KPMG observation**

The proposed GILTI deduction of 37.5%, together with the proposals to reduce the foreign tax credit haircut to 5% and eliminate the requirement to allocate U.S. expenses for purposes of section 904 (both discussed below), would require a foreign effective tax rate in excess of 17.43% to avoid residual GILTI. In contrast, the Green Book proposed a 25% GILTI deduction in the context of a 28% corporate headline rate and was silent on whether the haircut would be retained or reduced. Due to competitiveness concerns expressed by some moderate House Democrats, including in an August 4 letter to Chairman Neal signed by 11 Democrats, including six members of the House Ways and Means Committee, urging “a legislative approach that reflects the substance and timeline of negotiations at the OECD, it is not surprising that the House took a more measured approach. It is also possible that the GILTI rate will continue to converge toward the 15% rate for the Pillar 2 minimum tax that is currently being negotiated at the OECD.

**Favorable treatment of taxpayers with unrelated losses**

The most noteworthy change may be that the proposal would significantly change the computation of the section 250 deduction for corporations that have NOLs or otherwise have taxable income less than their combined FDII and GILTI due to unrelated losses. First, the proposal would eliminate the rule that limits the section 250 deduction based on the current year taxable income (the taxable income limitation). Second, the proposal would eliminate a rule that disregards the section 250 deduction in determining the amount of an NOL that carries forward to a year. These changes would be effective for tax years beginning after December 31, 2021.

**KPMG observation**

Under current law, a taxpayer with a loss calculates their NOL and NOL carryforwards without regard to the section 250 deduction. In addition, the taxable income limitation causes a company with less total taxable income than the sum of its FDII and GILTI (for example, when it has a loss from its domestic business but has a GILTI inclusion from its CFCs) to have a reduced section 250 deduction. Under both circumstances, because an unused section 250 deduction cannot be carried to any other year, the taxpayer permanently loses the benefit of their section 250 deduction. The proposal would provide relief to these taxpayers by treating a section 250 deduction like any other business deduction, including by permitting the deduction to either increase an NOL for the year or
decrease the amount of NOL carryforward absorbed in such year.

**Additional exclusions from deduction eligible income**

The proposal would exclude three additional categories of income from deduction-eligible income ("DEI"):

- Income "of a kind" that would be foreign personal holding income ("FPHCI") under the subpart F rules;
- Income from passive foreign investment companies ("PFICs") for which the U.S. shareholder has made a "qualified electing fund" ("QEF") election; and
- Disqualified extraterritorial income, which is gross income with respect to a transaction if any income from the transaction could be excluded from gross income by reason of the transition rules in the American Jobs Creation Act of 2004 (the "AJCA") that repealed the extraterritorial income ("ETI") regime.

With respect to the last exclusion, the AJCA provided continued benefits for income that would have been ETI under the ETI regime with respect to transactions entered into during the two-year transition period following ETI repeal or pursuant to a binding contract with an unrelated person that was in effect on September 17, 2003. As an alternative to excluding disqualified extraterritorial income from DEI, taxpayers may irrevocably elect to not apply the transition rules in the AJCA for the year of the election and all succeeding tax years.

The new exclusions from DEI are proposed to be effective for tax years beginning after December 31, 2017, consistent with the effective date of section 250 under the TCJA.

**KPMG observation**

The JCT explanation of the TCJA indicates that Congress intended to exclude from DEI income of a kind that would be FPHCI and income from QEFs, although it acknowledged that a technical correction may be required to effectuate that intent. All three proposed exclusions from DEI were included in a discussion draft of technical corrections with respect to the TCJA released by the outgoing Ways and Means chairman Kevin Brady on January 2, 2019.

**KPMG observation**

The new exclusion for income of a kind that would be FPHCI under subpart F is intended to apply to payments to a U.S. taxpayer that, if made to a CFC, would be FPHCI. Very generally, FPHCI includes interest, rents, and royalties not associated with an active business, gains from the disposition of property that gives rise to such income, foreign currency gains over foreign currency losses; and other types of passive income. However, presumably all of the relevant exceptions to FPHCI would apply as if the U.S. taxpayer were a CFC. For example, for tax years beginning before January 1, 2026, royalties received by a CFC from related parties are not treated as FPHCI to the extent the royalties are attributable to income that would neither be subpart F income nor effectively connected with a U.S. trade or business. As another example, the excess of foreign currency gains over foreign currency losses is generally included in FPHCI, subject to whether the
business needs exception applies. However, the new exception for income of a kind that would be FPHCI would not appear to apply to an excess of foreign currency losses over gains, so such excess would presumably reduce DEI.

Many types of income that are included in FPHCI, such as dividends and interest, are otherwise ineligible to be treated as foreign-derived deduction eligible income (“FDDEI”), which limits the potential impact of this proposal to some degree. Nevertheless, income from sales of an intangible to a CFC that would be FDDEI under current law could result in FPHCI if earned by a CFC, and therefore could, in certain cases, be excluded from DEI and FDDEI under the proposal. In addition, the treatment of income recognized under section 367(d) as DEI and FDDEI could be unclear in certain instances because of the ambiguity under current law regarding whether such income is properly treated as arising from a sale or a deemed royalty.

Coordination with the removal of foreign branch category income

Foreign branch income is currently one of the categories of income that is excluded from DEI, and it is defined by cross reference to the definition of foreign branch category income in section 904(d)(2)(j). As described above, for FTC limitation purposes, the proposal would eliminate the separate category for foreign branch income. The proposal would also make conforming changes to the definition of DEI to reflect the removal of the foreign branch category by replacing the reference to foreign branch income with a new subclause. The new subclause would exclude from DEI income that is attributable to branches or pass-through entities in one or more foreign countries. Further, the proposal would provide that the amount of income attributable to a branch or pass-through entity for purposes of determining DEI would be determined by regulation. The proposal would apply to tax years beginning after December 31, 2021.

KPMG observation

Under proposed section 250 regulations issued in 2019, foreign branch income was defined to include not only income described as “foreign branch income” in proposed regulations issued under section 904, but also income from a disposition of an interest in a disregarded entity or partnership. In response to comments questioning the authority of this rule, the final regulations under section 250 conform the definition of “foreign branch income” to the definition in the final section 904 regulations, thereby allowing income from dispositions of certain entities to be included in DEI and, potentially, FDDEI. Under the proposed rule, the determination of income attributable to branches or pass-through entities is no longer directly linked to the definition of foreign branch income for FTC limitation purposes. Accordingly, this proposal provides the government more latitude to consider the scope of the exception for income attributable to a branch for purposes of FDII.

KPMG observation

In contrast to proposals by the Biden Administration and Senator Wyden, the proposal would make relatively modest changes to section 250. The Biden Administration’s proposal set forth in the Green Book would repeal section 250 and replace it with an unspecified R&D incentive, whereas Senator Wyden’s proposal, previewed in his recently released discussion draft, would replace “deemed intangible income” with a new metric based on a percentage of qualifying expenditures for domestic research and development and worker training. However, even if the House proposal
becomes law, the long-term viability of the FDII regime remains in some doubt. 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 the section 250 deduction is consistent with the administration’s efforts to re-engage in multilateral tax cooperation, particularly at the OECD.

The JCT has estimated that the proposal would raise approximately $96.447 billion over a 10-year period.

**Changes to the subpart F rules**

**Foreign base company sales and foreign base company services income**

Subpart F income includes foreign base company sales income and foreign base company services income. In general, foreign base company sales income is income of a CFC derived in connection with the purchase of property from, or sale of property to, a related person or on behalf of a related person. Foreign base company services income generally is income of a CFC derived from performing services outside the CFC’s country of incorporation for or on behalf of a related person. For this purpose, related person is determined based on a “more than 50 percent” vote or value standard.

The proposal would limit the definition of “related person” for purposes of determining foreign base company sales income and foreign base company services income to include only a related person that is a “taxable unit” (as proposed to be defined for foreign tax credit purposes and discussed above) that is a tax resident of the United States. The proposal also would repeal the branch rules that apply for purposes of determining foreign base company sales income. In addition, the proposal would provide the Secretary with authority to issue guidance under the foreign base company sales income rules, including guidance for applying the new limitation to the related person definition to a series of transactions involving a taxable unit that is a U.S. tax resident.

The proposal would apply to tax years of foreign corporations beginning after December 31, 2021, and to tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

**KPMG observation**

The proposal would limit transactions that generate foreign base company sales income and foreign base company services income to related party sales and services transactions involving U.S. tax residents including pass through entities that are U.S. tax residents and branches that give rise to a taxable presence in the United States. Related party sales and services transactions between a CFC and a foreign related party without a U.S. taxable presence generally would generate tested income that would be taken into account in determining GILTI inclusions.

**KPMG observation**

The effect of these rules is to further shift subpart F to focus exclusively on U.S. base erosion rather than foreign-to-foreign base erosion. This trend is not new. It arguably began (albeit perhaps inadvertently) with the adoption of the check-the-box regulations in 1996, which allowed the use of hybrid branches to avoid the application, in particular, of the foreign base company sales rules. Section 954(c)(6), first enacted on a temporary basis in 2005 but repeatedly extended ever since,
appears to represent a more considered step in this direction by allowing dividends, interest, rents, and royalties received from a related CFC to be excluded from foreign personal holding company income if paid out of earnings that are neither subpart F income nor income that is effectively connected with a U.S. trade or business. Finally, Notice 2007-13 limits the substantial assistance rules that apply for purposes of determining foreign base company services income to only consider assistance provided by U.S. persons to CFCs. This new proposal continues, this trend of carving out of subpart F income foreign-to-foreign related party payments arising from active earnings.

Taken together with the enactment of GILTI (which changes the stakes from current inclusion vs. indefinite deferral to one of what U.S. tax rate will be applied) these changes are consistent with the view of many policymakers that a balance is required between addressing foreign-to-foreign base erosion and the resulting indirect risks that lightly taxed foreign earnings pose to the U.S. base, and competitiveness concerns arising by imposing U.S. tax on foreign-to-foreign transactions when our trading partners do not have similar rules. In contrast, some of these same policymakers assert that subpart F should be retained to tax at the full U.S. headline rate income that arguably reflects more direct erosion of the U.S. base.

KPMG observation

The proposal would not revise the current definition of related person other than by adding the new limitation, which is in a separate subsection from the related person definition. As a result, the new limitation does not appear to modify the general definition of related person that applies, via cross reference, for other subpart F purposes as well as other Code provisions. For example, the new limitation would not appear relevant for purposes of determining related persons when applying the look through rule in section 954(c)(6) or the passive foreign investment company rules related to income received from related persons. On the other hand, the limitation clearly would apply for purposes of the foreign base company sales income rules, as it is included in that subsection, and for purposes of the foreign base company services income rules because the proposal would explicitly revise the definition of related person in those rules to incorporate the new limitation.

KPMG observation

Although the term “taxable unit” in the new limitation to the definition of related person explicitly is defined by cross-reference to the definition of the term in section 904(e), there is no definition, including no similar cross reference to the section 904 definition, of “tax resident” of the United States.

KPMG observation

Unlike the Green Book, the subpart F high-tax exception is retained in the proposal. As a result, subpart F income items subject to a high rate of tax could be excluded both from subpart F income and from tested income for GILTI purposes.
Pro rata share

A U.S. shareholder determines its subpart F inclusion based on its pro rata share of subpart F income. Under current law, a U.S. shareholder has a pro rata share of subpart F income only if it owns, directly or indirectly under section 958(a), the stock of a foreign corporation on the last day of the year on which the corporation is a CFC. A U.S. shareholder’s pro rata share of the subpart F income of a CFC is generally determined based on the amount of the CFC’s current earnings and profits such shareholder would receive in a hypothetical distribution with respect to its shares. For purposes of this rule, subpart F income of a CFC is reduced if the CFC is not a CFC for the entire year. In addition, under section 951(a)(2)(B), a U.S. shareholder’s pro rata share with respect to a CFC is reduced if another person receives a distribution as a dividend during the year with respect to the stock of the CFC owned by the U.S. shareholder (e.g., a pre-acquisition distribution to the seller of such stock). Similar rules generally apply for purposes of determining a U.S. shareholder’s pro rata share of tested items for GILTI inclusion purposes.

The proposal would make two significant modifications to the current pro rata share rules. First, it would make it possible for a U.S. shareholder that owns (under section 958(a)) stock in the CFC on any day during the tax year to have a pro rata share of that CFC’s subpart F income even if the shareholder does not own the CFC on the last day of the year on which it is a CFC (i.e., it would eliminate the current “last day” rule of section 951(a)(1)). Second, the proposal would limit the circumstances under which a dividend distribution to another person would reduce a U.S. shareholder’s pro rata share, including by permitting a reduction only if the dividend is taxable to a U.S. person.

The proposal would provide different rules for calculating a U.S. shareholder’s pro rata share with respect to a share of CFC stock based on whether the U.S. shareholder owns (under section 958(a)) such stock on the last day of the CFC’s year in which it is a CFC (the “last relevant day”). Because the pro rata share determination would be made on a share-by-share basis, both sets of rules can apply to a single U.S. shareholder in a single tax year, for example, if the U.S. shareholder sells some, but not all, of its shares before the last relevant day.

In the case that the U.S. shareholder owns the CFC stock on the last relevant day, the U.S. shareholder’s pro rata share of the CFC’s subpart F income would be based on the subpart F income of the CFC after reduction for nontaxed current dividends, determined under rules discussed below, received by any other U.S. shareholder that owned the stock during the year prior to the ownership by the U.S. shareholder. In addition, like current section 951(a)(2)(B), the proposal generally would permit a reduction of such U.S. shareholder’s pro rata share with respect to a share of CFC stock to the extent of dividends paid with respect to the stock to another person. However, under the proposal this reduction would be permitted only for dividends that (i) do not qualify for a section 245A deduction (or, in a tiered CFC structure, are not excluded from the recipient CFC’s subpart F income under the high-tax, related party dividend, or look through exceptions; (ii) are paid out of current earnings and profits; (iii) are received by a U.S. person; (iv) are received after the U.S. shareholder’s period of ownership; and (v) are paid while the corporation was a CFC.

In the case of a U.S. shareholder that owns (under section 958(a)) a share of CFC stock during the tax year, but does not own (under section 958(a)) the share on the last relevant day, the U.S. shareholder’s pro rata share of the subpart F income of the CFC with respect to such share is generally based on the proportionate share of current year earnings and profits received with respect to the share as a nontaxed current dividend. The proposal would define a “nontaxed current dividend” as (i) the portion of a dividend (determined without regard to the proposal) received from the CFC out of current year earnings and profits that would be eligible for a section 245A deduction; or (ii) in a tiered CFC structure, the portion of a dividend (again, determined without regard to the proposal) paid by a lower-tier CFC out of current year earnings and profits to an upper-tier CFC that was excluded from the upper-tier CFC’s subpart F income.
under the subpart F high tax, same country dividend, or look through exceptions.

The proposal would revise the rules for calculating a U.S. shareholder’s pro rata share of CFC tested items for GILTI inclusion purposes in a similar manner, as well as the pro rata share rules applicable to captive insurance companies under section 953(c).

In addition, the proposal would provide authority for the Secretary to issue regulations providing additional guidance under section 951(a) on determining the amounts included in gross income of U.S. shareholders, including guidance: (i) to treat a partnership as an aggregate of its partners; (ii) to provide rules allowing a foreign corporation to close its tax year upon a change in ownership; and (iii) to treat a distribution followed by an issuance of stock to a shareholder not subject to tax under chapter 1 of the Code in the same manner as an acquisition.

The proposal would apply to distributions made after December 31, 2017.

KPMG observation

The proposal to revise the pro rata share rules is substantially identical to a proposal included in the Brady technical corrections bill with respect to TCJA. The proposal appears to be aimed principally at certain consequences arising from the interplay of section 245A, which allows a dividend received deduction for certain dividends received by a domestic corporation from a CFC, with section 951(a)(2)(B), which allows a reduction to a U.S. shareholder’s pro rata share for dividends paid by a CFC to persons that owned the CFC stock other than the U.S. shareholder. Under current law, without regard to the rules in Reg. § 1.245A-5, a sale of CFC stock by one corporate U.S. shareholder (the Seller) to another U.S. shareholder (the Buyer) could result in a dividend to the Seller under section 1248 that is nontaxable by reason of section 245A, while such dividend could still reduce the Buyer’s pro rata share of the subpart F income of the CFC for the year under section 951(a)(2)(B). This would result, effectively, in the CFC’s subpart F income for the year being included in the income of neither Buyer nor Seller. If, however, the proposal had simply repealed section 951(a)(2)(B) to prevent this result, without otherwise revising the pro rata share rules, in particular the “last day” rule of section 951(a)(1), the consequence would be that Seller would take into account 100% of the subpart F income of the CFC. This would ensure that the full amount of the CFC’s subpart F income is included in a U.S. shareholder’s income, but it would also create a capital loss in the Buyer’s CFC stock by operation of section 961(a), which could subsequently be used to offset any other capital gain. In contrast, this proposal would ensure that the Seller generally takes into income the CFC’s subpart F income to the same extent that the Seller benefits in the form of nontaxable dividends from the earnings and profits created by this subpart F income, whereas the Buyer only takes into income the remaining subpart F income.

KPMG observation

The “extraordinary reduction” rules of Reg. § 1.245A-5(e) currently address the concern discussed immediately above, albeit through different mechanics. The extraordinary reduction rules deny the section 245A deduction for the Seller, while permitting the reduction to the Buyer’s pro rata share of subpart F income under section 951(a)(2)(B). In contrast, the proposal would allocate all or a portion of the subpart F income of the CFC to the Buyer, thus converting the section 245A eligible dividend to section 961(a) basis. In addition, both this proposal and the proposed reinstatement of section 958(b)(4), discussed in another part of this Report, would address another concern that motivated the extraordinary reduction rules, that, absent regulations to the contrary, the “last day”
rule of section 951(a)(1) in conjunction with section 958(b)(4) repeal can facilitate “out-from-under” transactions. Specifically, because of section 958(b)(4) repeal, a foreign-parented U.S. corporation could transfer a CFC to its foreign parent (or another foreign affiliate) without a subpart F inclusion, since, due to downward attribution, such transfer would not “de-CFC” the CFC and thus the U.S. corporation would not own stock (under section 958(a)) of the CFC on its last day as a CFC (i.e., the last day of its tax year). Under the proposal to reinstate section 958(b)(4), any such “out-from-under” transfer would generally de-CFC the CFC, thus triggering the last relevant day. Likewise, even if such transfer did not cause a last relevant day, the U.S. corporation would be allocated a pro rata share of the subpart F income of the CFC under the proposed revisions to the pro rata share rules. Therefore, the enactment of these proposals would render the extraordinary reduction rules largely redundant with the statute and thus might be expected to precipitate their withdrawal.

KPMG observation

The pro rata share rules, which the technical explanation generally refer to as “technical amendments” (i.e., to fix inadvertent errors in the TCJA), apply retroactively to distributions made after December 31, 2017, which is consistent with the effective date of section 245A. It is not entirely clear why the effective date refers to “distributions” because the proposal addresses the impact of distributions on pro rata share determinations, which are made as of the close of a CFC’s tax year, rather than the direct tax consequences of the distributions. If the proposal is enacted with a retroactive applicability date, taxpayers may need to review distributions made after December 31, 2017 in order to determine their treatment in prior tax years, including for current financial statement purposes.

KPMG observation

The proposal would not impact the determination of a US shareholder’s section 956 inclusion; a US shareholder could continue to have a section 956 inclusion with respect to a corporation only if owns under section 958(a) the corporation on the last day of the year in which the corporation is a CFC.

KPMG observation

Domestic partnerships are treated as an aggregate for purposes of determining GILTI inclusions under current law. In addition, domestic partnerships would be treated as an aggregate of its partners for purposes of determining subpart F inclusions and section 956 inclusions under a proposed regulation (proposed Reg. § 1.958-1(d)) published in 2019, which is expected to be finalized soon. The proposed rule would apply to tax years of foreign corporations that begin after the date the final regulation are published in the Federal Register. The proposal’s grant of regulatory authority to treat partnerships as aggregates for purposes of the pro rata share rules is consistent with the approach taken in the proposed rule.

Section 961(c)

Under current law, a U.S. shareholder generally increases its basis in a directly held CFC or its property through which it indirectly holds the CFC by the amount of subpart F inclusions or GILTI inclusions, and
reduces its basis by the amount of distributions of previously taxed earnings and profits. In addition, the Secretary has authority to issue regulations that would provide similar basis adjustments for an upper-tier CFC’s basis in a lower-tier CFC, although solely for purposes of determining the subpart F inclusions of its U.S. shareholders.

The proposal would extend the Secretary’s authority to provide rules similar to sections 961(a) and 961(b) for intermediate entities when a U.S. shareholder indirectly owns a CFC through a chain of entities. Specifically, the proposal would allow the Secretary to provide basis adjustments in property by reason of which a U.S. shareholder is treated as owning a CFC, in addition to CFCs held through chains of CFCs. Further, the proposal would remove the limitation that the basis adjustments apply only for purposes of determining subpart F inclusions. In addition, the proposal broadens the Secretary’s authority from providing “adjustments similar to” those in section 961(a) and (b) to providing “rules similar to” section 961(a) and (b).

The proposal generally would apply to tax years of foreign corporations beginning after December 31, 2021 and to tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

**KPMG observation**

The proposal would eliminate the current law limitation imposed on section 961(c) basis, which is taken into account only for purposes of determining a U.S. shareholder’s subpart F inclusion (and not, for instance, for purposes of calculating earnings and profits). In other words, under this proposal, the Secretary is authorized to provide that section 961(c) basis, whether it arises by reason of a subpart F inclusion or a GILTI inclusion, is basis for all U.S. tax purposes. Therefore, the proposal would resolve the debate under current law as to whether section 961(c) basis is taken into account for purposes of calculating tested income for GILTI purposes.

**KPMG observation**

While the proposal expands the Secretary’s authority under section 961(c) to provide for basis adjustments to all CFCs and non-corporate entities in the chain of ownership between CFCs, the grant of authority does not explicitly cover adjustments to the basis of CFC stock owned by a non-corporate entity that is not itself owned by a CFC. For instance, if USP owns CFC1, which owns FPS, a foreign partnership, which owns CFC2, this proposal would authorize regulations to provide adjustments to CFC1’s basis in its FPS interest, in addition to the basis adjustments under current section 961(a) to USP’s CFC1 stock and the basis adjustments authorized under current section 961(c) to FPS’s basis in CFC2 stock. In contrast, if USP owns FPS, which owns CFC1, USP’s subpart F inclusion with respect to CFC1 would result in adjustments to USP’s basis in its FPS interest under section 961(a), but neither section 961(a) under current law nor section 961(c) as proposed would explicitly authorize adjustments to FP’s basis in CFC1 stock.

**KPMG observation**

Current law section 961(c) authorizes regulations to provide for “adjustments similar to the adjustments” in section 961(a) and (b) to lower-tier CFC stock owned by an upper-tier CFC, but does not explicitly authorize regulations to apply the gain recognition rule of section 961(b)(2) to the
extent distributions of PTEP from the lower-tier CFC to the upper-tier CFC exceeds the basis in the lower-tier CFC’s stock. The proposal would no longer apply the “adjustments” in section 961(a) and (b), but rather the “rules” of such subsections. According to the technical explanation, this proposal “clarifies” that the gain recognition rule of section 961(b)(2) is intended to be incorporated into section 961(c). Thus, the proposal would resolve a longstanding open issue under current law as to the scope of “adjustments” authorized under section 961(c).

The JCT has estimated that the changes in section 138129 of the proposal would raise approximately $20.622 billion over a 10-year period.

Repeal of election for one-month deferral in determination of tax year of specified foreign corporations

Under current section 898, “specified foreign corporations” (SFCs), usually corresponding to CFCs that are majority owned by a single U.S. shareholder) are generally required to follow the tax year of their majority U.S. shareholder. A notable exception exists, however, in that an SFC may elect to use a tax year beginning one month earlier than the majority U.S. shareholder’s tax year (the “one-month deferral rule”).

For example, an SFC with a calendar year majority U.S. shareholder will default to the same December 31 year-end or can make the one-month deferral election to use a tax year ending November 30.

The proposal eliminates the one-month deferral option for an SFC’s first tax year beginning after November 30, 2021. SFCs must thereafter conform to the majority U.S. shareholder’s year. A special transition rule provides that SFCs with one-month deferral elections in place would have, for their first year beginning after November 30, 2021, a one-month short year as the mechanism to conform to the majority U.S. shareholder year. For calendar year taxpayers, this means that any in-scope SFCs would have a short year from December 1, 2021 to December 31, 2021, and then would have a calendar tax year for 2022 and onwards.

The JCT has estimated that the proposal would raise approximately $21.811 billion over a 10-year period.

KPMG observation

The repeal of the one-month deferral rule appears to be a new proposal that was not included in prior Green Books from the Biden or Obama Administrations.

The potential mismatch in the tax years of U.S. shareholders and their SFCs that had elected the one-month deferral option created numerous anomalies in the application of changes made by the TCJA, including the applicable tax rates for section 965 and the divergence in the effective dates for the section 245A dividends received deduction and the (then-) new GILTI rules. Thus, it is perhaps unsurprising that the House proposal seeks to foreclose the potential for similar anomalies to arise from the current tax reform process.

KPMG observation

The transition rule could result in lost GILTI FTCs for CFCs that have made one-month deferral
elections and have different foreign tax year ends. A CFC that currently has a November 30 year-end for U.S. tax purposes and a December 31 year-end for local tax purposes accrues its foreign income taxes for deemed paid FTC purposes on December 31, the last day of the foreign tax year. Thus, the CFC’s foreign income taxes for 2021 would accrue during the CFC’s one-month short period created by the transition rule. The disproportionate tax accrual may mean that the taxes exceed the CFC’s tested income for the short period, causing a tested loss, with the result that the taxes are permanently stranded. Alternatively, the U.S. shareholder could have a GILTI inclusion based on thirteen months of tested income (the tested income for the year ended November 30, 2021 and the short period) along with two years of tax accruals (December 31, 2020 and December 31, 2021), with the result that section 960 would produce an artificially high effective rate of tax on the GILTI inclusion in excess of the taxpayer’s 904 limitation. This could potentially lead to lost GILTI FTCs.

Proposals that could alleviate this result, including the proposals to allow GILTI FTCs to be carried forward or to aggregate income and losses (and the associated taxes) within the same country, would not be effective until the following tax year. It may be appropriate for legislators to consider transitional relief for excess credits and tested losses arising from the section 898 transition rule, for example by revising the effective date in the GILTI FTC rules to allow excess credits from the one-month short-period to be carried forward or by modifying the current law denial of FTCs that accrue in a tested loss year.

**Adjustments to earnings and profits of CFCs**

A CFC’s earnings and profits generally are determined according to rules substantially similar to those applicable to domestic corporations. Ordinarily, earnings and profits are considered to arise at the same time that a corporation recognizes taxable income. In certain cases, however when the Code has special rules deferring the inclusion of taxable income vis-a-vis the receipt of property that could support a distribution to shareholders, section 312 de-links the recognition of earnings and profits from taxable income recognition. Specifically, under these special rules, a corporation determines its earnings and profits without regard to LIFO method (section 312(n)(4)), installment sales (section 312(n)(5)), and completed contracts method of accounting (section 312(n)(6)). The effect of ignoring these accounting methods is that earnings and profits are generally accelerated relative to the corresponding taxable income determinations.

In the subpart F context, however, because of the alignment between earnings and profits and the subpart F limitation in section 952(c), a mismatch between earnings and profits and taxable income could lead to subpart F income of a CFC going untaxed. To address this possibility, existing section 952(c)(3) effectively disregards the section 312(n)(4)-(6) special E&P rules for purposes of the subpart F limitation in section 952(c). Thus, for example, a CFC’s earnings and profits from an installment sale, while recognized currently for regular earnings and profits purposes, are not recognized for subpart F limitation purposes until the corresponding income is recognized by the CFC under the installment sale rules.

**KPMG observation**

Section 952(c)(3) includes a grant of regulatory authority to reinstate the section 312(n)(4)-(6) rules’ acceleration of E&P recognition for subpart F limitation purposes, if disregarding those rules would increase earnings and profits by an amount which was previously distributed. For example, under such a rule, if a CFC distributed earnings and profits from the proceeds of an installment sale prior
to the installment gain being recognized, the CFC's subpart F limitation would exclude the installment sale gain earnings in the later year. Absent other income and earnings in that later year, the CFC would technically have subpart F income but there would be no inclusion for the CFC's U.S. shareholder(s); instead a section 952(c) recapture account would arise. However, this grant of regulatory authority has not been exercised by Treasury in the 33 years since section 952(c)(3) was enacted as part of the 1988 technical corrections bill to the 1986 Tax Reform Act.

The proposal strikes section 952(c)(3) and replaces it with a similar special rule in section 312(n)(9), which precludes the application of section 312(n)(4)-(6) to CFCs. The proposal thus re-aligns, for purposes of applying the three special accounting rules at the CFC level, the determination of earnings and profits with the CFC's taxable income computation. The staff summary states that relocating the rule from 952(c)(2) to section 312(n) would make the rule apply more generally to determine earnings and profits of CFCs. The proposal would not maintain the potential regulatory exclusion with respect to previously distributed earnings and profits.

The amendments are proposed to be effective for taxable years beginning after December 31, 2021. The JCT has estimated that the proposal would raise approximately $4.875 billion over a 10-year period.

**Deduction for foreign source portion of dividends limited to CFCs, etc.**

**Reinstatement of section 958(b)(4)**

The proposal would reinstate section 958(b)(4), which before the TCJA prevented "downward attribution" of stock ownership from a foreign person to a U.S. person for purposes of determining whether a U.S. person is a U.S. shareholder or whether a foreign corporation is a CFC. The TCJA repealed section 958(b)(4) effective for the last tax year of CFCs that began before January 1, 2018, and the tax year of U.S. persons in which or with which such tax year ends. The effective date of the proposal is the same as that of the repeal of section 958(b)(4) under the TCJA. Therefore, the proposal would treat section 958(b)(4) as never having been repealed.

**KPMG observation**

The legislative history of the TCJA indicates that the repeal of section 958(b)(4) was aimed at certain "de-control" transactions in which a foreign corporation controlled by a foreign-parented U.S. shareholder ceased to be a CFC by reason of a dilutive investment (e.g., foreign parent contributes property to the foreign corporation for a 51% interest in the corporation). Thus, according to the legislative history, the repeal of section 958(b)(4) was not intended to cause a foreign corporation to be treated as a CFC with respect to a U.S. shareholder if such U.S. shareholder is unrelated to the U.S. person to which ownership of stock in the foreign corporation is attributed. Nonetheless, the enacted statutory language did not contain any restriction on downward attribution.

As a result of the repeal of section 958(b)(4), the number of foreign corporations treated as CFCs has proliferated since the TCJA. In particular, any foreign corporation in a foreign-parented group, other than the foreign parent itself, is a CFC if that group includes at least one U.S. subsidiary. If a U.S. shareholder owns stock under section 958(a) in such CFC, that U.S. shareholder is generally required to include amounts in income with respect to the CFC under sections 951, 951A, 956 and 965 (collectively the "CFC inclusion rules"), regardless of whether such U.S. shareholder or the CFC are related. For instance, a U.S. person that owns 10% of the stock in a foreign parent, but is otherwise unrelated to such foreign parent, is a U.S. shareholder of that foreign parent’s wholly
owned foreign subsidiaries and thus could be required to include the income of such foreign subsidiaries into its gross income under the CFC inclusion rules if such foreign subsidiaries are treated as CFCs by reason of downward attribution to a U.S. subsidiary of the foreign parent. Although the government provided some relief through a 2019 Revenue Procedure, section 958(b)(4) repeal has increased compliance burdens due to the information reporting provisions that are triggered by U.S. shareholder or CFC status.

The proposed reinstatement of section 958(b)(4), with retroactive effect, would address the policy concerns that motivated section 958(b)(4) repeal with more targeted provisions (in particular new section 951B) that give effect to the legislative history. Importantly, because section 958(b)(4) would be treated as having never been repealed, if the proposal is passed with current effective dates, taxpayers that are U.S. shareholders of foreign corporations that were CFCs solely by reason of section 958(b)(4) repeal (sometimes referred to as “faux CFCs”) but are not subject to the CFC inclusion rules under section 951B (because they are not “foreign controlled” U.S. shareholders) may be entitled to a refund for an open tax year between 2017 and 2021 if they reported taxable income from their faux CFCs under the CFC inclusion rules. However, some taxpayers may find it beneficial to make an election, which is discussed in more detail below, to continue to treat their former faux CFCs as CFCs in order to take into gross income the earnings of such corporations as subpart F or GILTI inclusions instead of as taxable dividends when distributed. For instance, an individual U.S. shareholder might prefer the lower tax rate afforded to its inclusion with respect to a CFC under the mandatory repatriation rules of section 965 rather than the taxation of dividends from the CFC at the individual’s highest marginal rate.

Rules applicable to foreign controlled CFCs

The proposal would add a new section 951B that would apply to “Foreign Controlled U.S. shareholders” (“F-USSH”) of “Foreign Controlled CFCs” (“F-CFC”), with an effective date tied to the effective date for the reinstatement of section 958(b)(4). These new defined terms are based on the existing definitions of U.S. shareholder and CFC, but have different ownership thresholds and, importantly, constructive ownership would be determined without regard to section 958(b)(4). While, as discussed above, section 958(b)(4) is generally proposed to be reinstated, this proposal would effectively treat section 958(b)(4) as repealed solely for purposes of determining whether section 951B applies to a particular U.S. shareholder of a foreign corporation.

Specifically, section 951B would define an F-USSH as a U.S. person that owns more than 50% of the voting power of the F-CFC for the 2017 tax year, or more than 50% of the voting power or value of the F-CFC for tax years after 2017, determined under the section 958(a) and (b) constructive ownership rules other than section 958(b)(4). As a result, downward attribution from foreign persons would be taken into account in determining whether a U.S. person is an F-USSH. Similarly, a foreign corporation would be an F-CFC if more than 50% of its voting power or value was owned by F-USSH, determined under the section 958(a) and (b) constructive ownership rules other than section 958(b)(4). Thus, the expanded downward attribution rules would apply for purposes of determining whether a foreign corporation is an F-CFC.

Generally, an F-USSH of an F-CFC would be subject to the CFC inclusion rules in the same manner as a U.S. shareholder is subject to those rules with respect to a CFC under the definition of section 957. Accordingly, an F-USSH would be subject to the CFC inclusion rules under section 951B only if it owns stock in the F-CFC directly or indirectly within the meaning of section 958(a).

Section 951B would provide Treasury and the IRS authority to issue regulations or other guidance that may be necessary or appropriate to carry out the purposes of the section, including regulations or other
KPMG observation

Taxpayers that were affected by the repeal of section 958(b)(4) would need to review their structures dating back to 2017 to determine whether they would be subject to the new F-CFC rules. The diagram below illustrates a structure that would result in an F-USSH of an F-CFC under the proposal:

In this diagram, US Sub owns (under section 958(a)) 9% of Foreign Sub. Based on the proposed reinstatement of section 958(b)(4), US Sub would not be treated as owning the Foreign Sub stock owned by Foreign Parent. Thus, US Sub would not be a U.S. shareholder of Foreign Sub and Foreign Sub would not be a CFC. But under proposed section 951B, US Sub would constructively own the remaining 91% of Foreign Sub as a result of downward attribution of Foreign Parent’s ownership of Foreign Sub for purposes of qualifying US Sub as an F-USSH and Foreign Sub as an F-CFC. As a result, US Sub would be subject to the CFC inclusion rules based on its 9% ownership in Foreign Sub as under current law, except that the operative provision would be section 951B rather than sections 951(a) and 951A.

Importantly, however, USSH would not be subject to the CFC inclusion rules, including by reason of section 951B. With respect to sections 951(a) and 951A, USSH is a U.S. shareholder of Foreign Sub, but, without regard to downward attribution (i.e., because of section 958(b)(4) reinstatement), Foreign Sub would not be a CFC because no U.S. person would be treated as owning more than 50% of the vote or value of Foreign Sub. With respect to section 951B, USSH would not be a F-USSH, because USSH would not be treated as owning more than 50% of either Foreign Parent or Foreign Sub even by operation of downward attribution (i.e., if section 958(b)(4) were repealed).

This table summarizes the treatment of US Sub and USSH under prior, current, and proposed law:
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<th>Pre-TCJA</th>
<th>Current Law</th>
<th>Proposal</th>
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<tbody>
<tr>
<td>US Sub CFC</td>
<td>CFC inclusion rules did not apply</td>
<td>CFC inclusion rules apply</td>
<td>CFC inclusion rules would apply under section 951B</td>
</tr>
<tr>
<td>US Sub USSH</td>
<td>CFC inclusion rules did not apply</td>
<td>CFC inclusion rules apply</td>
<td>CFC inclusion rules would not apply</td>
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</tbody>
</table>

KPMG observation

**Information reporting.** The proposal does not contain any new information reporting requirements. The current information reporting triggered by U.S. shareholder or CFC status would not seem to automatically apply to an F-USSH or an F-CFC (unless it separately met the U.S. shareholder or CFC definition). For example, F-USSHs of F-CFCs would not fall within any of the “categories” of filers currently listed in the recently released draft Instructions to Form 5471. Nonetheless, it seems likely that, under the broad grant of regulation authority included in proposed section 951B, the IRS would impose new information reporting obligations on F-USSHs that have CFC income inclusions under section 951B.

KPMG observation

**Impact on section 965.** The proposal would generally reduce the number of taxpayers subject to mandatory repatriation. If enacted, the reinstatement of section 958(b)(4) and addition of section 951B would apply beginning with the last tax year that begins before January 1, 2018, which is the tax year to which mandatory repatriation under section 965 applies. Domestic corporations that were U.S. shareholders (without regard to section 958(b)(4) repeal) of faux CFCs in that year would generally still be subject to mandatory repatriation, because section 965 applied to any domestic corporation that was a U.S. shareholder of a foreign corporation, regardless of whether such foreign corporation was a CFC. In addition, domestic corporations that would not have been U.S. shareholders of a foreign corporation but for section 958(b)(4) repeal could be subject to section 965 under section 951B if such U.S. shareholder satisfies the definition of a F-USSH and the foreign corporation satisfies the definition of a F-CFC. However, the relatively higher ownership threshold for determining F-USSH status—50%, as compared with 10%—would result in fewer F-USSHs, and, thus, fewer persons subject to mandatory repatriation. In particular, a minority U.S. shareholder of a former faux CFC that is unrelated to the U.S. person to whom the former faux CFC’s stock is being attributed may no longer be subject to section 965. Taxpayers that were subject to mandatory repatriation with respect to a foreign corporation as a result of the repeal of section 958(b)(4) would need to redetermine whether they are subject to mandatory repatriation under the revised statute. The proposal does not discuss any of the procedural issues that would be implicated by revising 2017 tax law after the due date for filing 2017 tax returns (and potentially even the period for filing amended returns under the applicable statute of limitations) affected by the revision have passed.

KPMG observation

**PFIC.** It is unclear how these proposed additions to the Code could interact with existing Code provisions, including the passive foreign investment company (“PFIC”) rules. The overlap rule in the PFIC provisions that turns off the application of the PFIC rules with respect to a U.S.
shareholder that owns an interest in a foreign corporation that is both a CFC and a PFIC would not seem to apply to an F-USSH of an F-CFC that also is a PFIC. In that case, the F-USSH would be subject to tax under both the PFIC and subpart F regimes with respect to the F-CFC/PFIC, which seems contrary to the legislative intent of the overlap rule. Further, the overlap rule would no longer be applicable to U.S. persons that are U.S. shareholders of a CFC/PFIC solely as a result of the repeal of section 958(b)(4). On the other hand, the reinstatement of section 958(b)(4) would reduce the number of foreign corporations that are required to apply the PFIC asset test based on adjusted basis (rather than fair market value) as a result of their CFC status.

**Election to treat foreign corporation as a CFC**

The proposal would amend section 957(a) to permit taxpayers to make an election to treat a foreign corporation as a CFC with respect to all its U.S. shareholders. The election is made by the foreign corporation and all U.S. shareholders of such foreign corporation, determined at the time the election is made. The election applies to the foreign corporation and all U.S. shareholders of such foreign corporation, including any person who becomes a U.S. shareholder subsequent to the election, unless revoked with the consent of the Secretary. The time and manner for making the election is left to regulations. The election would not apply for purposes of section 951B or for any other purpose if the Secretary determines that treatment of such foreign corporation as a CFC for such purpose would be inconsistent with the purposes of subchapter N, which includes the subpart F and GILTI regimes. The proposal provides broad regulatory authority, including specific authority to address acquisitions of assets described in section 381(a) (e.g., an asset reorganization or a section 332 liquidation) from corporations that have elected to be treated as a CFC.

Similar to section 951B and the reinstatement of section 958(b)(4), this provision is effective for the last tax year of foreign corporations beginning before January 1, 2018 and tax years of U.S. persons in which or with which such tax years of foreign corporations end.

**KPMG observation**

The inapplicability of the CFC election for purposes of section 951B could be meant to address the fact pattern in which FP owns 100% of USS, and FP, USS, and unrelated USX own 81 %, 9 %, and 10 %, respectively, of FS. In this situation, if USS, USX, and FS combine to make an election to treat FS as a CFC, and if such election were effective for purposes of section 951B, FS would cease to an F-CFC for purposes of section 951B, since a CFC definitionally cannot be an F-CFC. While USX, as a U.S. shareholder of FS, a CFC, would take into account its pro rata share of the income of FS under the CFC inclusion rules under section 951B, USS, as a non-U.S. shareholder of FS after reinstatement of section 958(b)(4), would (were the election not limited in its scope) be able to entirely avoid the CFC inclusion rules.

Though this election would have no effect on USS by reason of the section 951B exception in this scenario, the proposal would still require USS to join in the election for USX to make an effective election, which would necessitate cooperation between USS and USX, unrelated parties. While this could be inconvenient, it is perhaps necessitated by the durability of the election; the election, while inapplicable to USS, would apply with respect to any U.S. shareholder that purchases stock in FS, including FS stock sold by USS. Whether a CFC election has been made with respect to a foreign corporation could become an important matter for consideration in M&A deals.
Section 245A limited to dividends from CFCs

Under current law, Section 245A provides a deduction for the foreign-source portion of a dividend ("section 245A DRD") received by a U.S. shareholder from a specified 10% owned foreign corporation. To be eligible for the section 245A DRD, in addition to satisfying the holding period requirements of section 246(c):

1) The payment must be a dividend;
2) The recipient of the dividend must be a domestic corporation that is a U.S. shareholder;
3) The payor of the dividend must be a “specified 10-percent owned foreign corporation”; and
4) The dividend must be paid out of the certain undistributed foreign earnings of the foreign corporation.

A specified 10% owned foreign corporation is any foreign corporation with respect to which any domestic corporation is a U.S. shareholder.

The proposal would limit the section 245A DRD to the foreign-source portion of a dividend received from a CFC. A dividend received from a specified 10% owned foreign corporation that is not a CFC would no longer be eligible for the section 245A DRD. The proposal would apply to distributions made after the date of enactment.

KPMG observation

Limiting the section 245A DRD to dividends from foreign corporations that are CFCs is a significant departure from current law. While there is no explanation for this change, it could be motivated, at least in part, by the theory articulated in the preamble to Reg. §1.245A-5T that section 245A should only be permitted to apply to the “residual” E&P left after the application of the CFC inclusion rules. While the proposal does not provide a section 245A DRD for payments from F-CFCs, which would be subject to the CFC inclusion rules under section 951B, as noted above, section 951B would provide authority to the Secretary to issue regulations treating F-USSH and F-CFCs as U.S. shareholders and CFCs, respectively, for purposes of section 245A.

The narrowing of the section 245A DRD may have adverse consequences for domestic corporations that own 10% or more of the shares of a foreign corporation that is not a CFC, including a foreign corporation that is a CFC under current law, but would not be a CFC due to the proposed reinstatement of section 958(b)(4). Under current law, dividends received by a U.S. shareholder from such a foreign corporation may be eligible for the Section 245A DRD. Under the proposal, such dividends would be taxable at the full corporate income tax rate.

Moreover, many multinational corporations may indirectly own 10% or more of the shares of a non-CFC through a CFC. Dividends from the non-CFC to the CFC constitute gross foreign personal holding company income. Although not statutorily prescribed, the legislative history to the TCJA indicates that the CFC recipient of the dividend income can be eligible for the Section 245A DRD, which, if available, would reduce the CFC’s net subpart F income attributable to such dividend to zero. The proposal would clearly disallow the Section 245A DRD in these circumstances. Thus, absent an exception, dividends from the non-CFC to the CFC would result in a subpart F inclusion, which would generally be taxable to the recipient CFC’s U.S. shareholder at the full corporate income tax rate.

As discussed in detail above, the proposal would allow a non-CFC to make an election to be treated as a CFC with respect to all U.S. shareholders. Assuming the Treasury and IRS exercise their regulatory authority in this regard, the election may allow a domestic corporation to claim a section
245A DRD with respect to dividends from an entity that would not otherwise be treated as CFC, provided that the section 245A DRD requirements are otherwise satisfied. However, the election would also require the U.S. shareholder to include in income its pro-rata share of the tested income and subpart F income of such entity. Moreover, a U.S. shareholder cannot unilaterally make the election; the election would require the consent of the foreign corporation, and any other U.S. shareholders of such corporation.

KPMG observation

Section 246(c)(5) provides special holding period requirements for dividends from specified 10% owned foreign corporations to obtain a section 245A DRD. The proposal does not purport to make conforming changes to section 246(c)(5). It is assumed that this is merely an oversight.

KPMG observation

The changes to section 245A are proposed to be effective only after date of enactment, whereas the reinstatement of section 958(b)(4) and the addition of section 951B would be retroactively effective to 2017 (for calendar year CFCs). This gap in effective dates between the section 245A proposal and section 958(b)(4) / section 951B proposals could permit corporate U.S. shareholders of faux CFCs that are not subject to section 951B to obtain refunds for any U.S. tax liability attributable to their inclusion of such CFCs’ earnings and income under the CFC inclusion rules while still obtaining a section 245A DRD for any dividends paid by such CFCs before date of enactment—including amounts treated as PTEP distributions under current law that would be converted into dividends by reason of the retroactive changes.

The JCT has estimated that the changes in section 138128 of the proposal would raise approximately $451 million over a 10-year period.

Certain dividends from CFCs to U.S. shareholders treated as extraordinary dividends

Section 1059 generally requires a basis reduction to shares with respect to which a corporate shareholder receives an extraordinary dividend in an amount equal to the non-taxed portion of such dividend if the shareholder has not owned the shares for at least two years. The non-taxed portion of a dividend is generally the amount of the deduction received with respect to such dividend under section 243, 245, or 245A. If the non-taxed portion of the dividend exceeds the basis in the shares with respect to which the dividend was received, the excess is treated as gain from the sale or exchange of the shares.

The proposal would expand the circumstances in which a corporate shareholder is required to make a basis reduction under section 1059. Specifically, any dividend paid by a CFC is a per se extraordinary dividend, regardless of whether the shareholder has owned the shares on which the dividend was paid for two or more years, if such dividend is attributable to E&P which (a) were earned by such CFC during a disqualified period or (b) are attributable to gain on property which accrued during a disqualified period. A disqualified period is, with respect to CFC stock on which a dividend is paid, any period during which (a) such foreign corporation was not a CFC or (b) such stock was not owned by a U.S. shareholder.

The proposed changes to section 1059 would apply to distributions made after the date of the enactment.
KPMG observation

It appears that this proposal is intended to backstop the proposed changes to section 245A with respect to E&P of a CFC that are attributable to periods of ownership before the foreign corporation was a CFC and thus never subject to the CFC inclusion rules. Any dividend out of such E&P would be afforded a section 245A DRD, but would then result in the reduction to basis in the stock (and thus potentially gain recognition) under section 1059. The effect of this proposal, in conjunction with section 245A, would be to effectively treat every dividend of pre-CFC E&P as a tax-free return of basis, to the extent thereof, and then capital gain.

KPMG observation

Current section 961(d) reduces the basis in the stock of a specified 10% owned foreign corporation owned by a U.S. shareholder by the amount of dividends for which the shareholder received a section 245A DRD, but solely for purposes of determining loss on any disposition of such stock. Because section 961(d) only applies to disallow losses on disposition, and not to increase the amount of gain, it has limited application. Indeed, if the proposal to section 1059 becomes law, section 961(d) would appear largely redundant, since section 961(d) most often arises in the same context as the proposal under section 1059—an acquisition of a non-CFC foreign corporation in a taxable transaction followed by a distribution by the foreign corporation of its historic earnings.

KPMG observation

It unclear why the proposal applies not only to E&P earned by a CFC during a disqualified period, but also to E&P earned by the CFC “attributable to gain on property which accrued” during that period. If, for instance, USP acquires FT from FP and fails to make a section 338(g) election with respect to FT, any gain in the assets of FT would, if recognized while owned by USP, be subject to the CFC inclusion rules. There is no obvious reason for treating a dividend out of the residual E&P from such asset gain, after taking into account the CFC inclusion rules, as a per se extraordinary dividend under section 1059. This could also be a major buy-side diligence issue for a U.S. acquirer of a non-CFC foreign corporation if no section 338(g) election is made; the acquirer would need to determine the precise amount of built-in gain in the assets of FT at the time of acquisition to be able to apply section 1059 to a subsequent distribution.

KPMG observation

The proposal applies to a dividend from a CFC attributable to E&P earned by the CFC during a disqualified period. As discussed above, a disqualified period is defined as any period during which (a) such foreign corporation was not a CFC or (b) such stock was not owned by a U.S. shareholder. With the reinstatement of section 958(b)(4), it is unclear what (b) is adding to the definition of disqualified period: without downward attribution from foreign periods, a CFC will generally have at least one U.S. shareholder that owns (under section 958(a)) stock of the CFC. Also, it is not clear how this proposal would operate in the case of tiered dividends, e.g., with respect to dividend received by a U.S. shareholder from an upper-tier CFC out of E&P created by reason of a dividend
Section 245A regulatory authority

Section 245A(g) provides Treasury with authority to provide regulations or other guidance as may be necessary or appropriate to carry out the provisions of section 245A, including regulations for the treatment of U.S. shareholders owning stock of a specified 10% owned foreign corporation through a partnership.

In 2020, Treasury and the IRS issued Reg. § 1.245A-5 (the “Section 245A Final Regulations”). The general rules of the Section 245A Final Regulations are the same as those included in former Reg. § 1.245A-5T (the “Section 245A Temporary Regulations”). The Section 245A Final Regulations disallow a section 245A DRD with respect to a dividend otherwise eligible for the deduction to the extent of the “ineligible amount” of the dividend. The ineligible amount of a dividend is generally the amount of the dividend that is equal to the sum of (1) 50% of the extraordinary disposition amount and (2) 100% of the extraordinary reduction amount.

The Section 245A Temporary Regulations were criticized from both a procedural and substantive standpoint. Procedurally, public comments questioned whether Treasury, in making the temporary regulations effective immediately, complied with the “notice and comment” rules in the Administrative Procedures Act (“APA”). Substantively, the temporary regulations were criticized for exceeding the scope of Treasury’s delegated authority. Treasury rejected the substantive comments in the preamble to the Section 245A Final Regulations, arguing that it had sufficient authority under sections 245(g), 954(c)(6)(A), and 7805(a) to issue the regulations, and referred back to the preamble of the earlier temporary regulations with respect to issues raised relating to the APA.

The proposal would expand the specifically enumerated topics on which the Secretary may issue guidance to include the denial of all or a portion of the section 245A DRD in situations in which (a) any portion of the dividend is out of E&P arising from non-ordinary course dispositions to related parties made on or after January 1, 2018, and during a tax year to which 951A did not apply or (b) a transfer or issuance of stock on or after January 1, 2018 results in a reduction in the US shareholder’s pro-rata share of CFC subpart F income or tested income. The amendment to section 245A(g) would be effective for distributions made after December 31, 2017. The added, retroactive regulatory authority provided by the proposal generally aligns with the substance of the Section 245A Final Regulations—i.e., rules designed to target extraordinary disposition and extraordinary reduction transactions.

Base erosion and anti-abuse tax (BEAT)

Modifications to BEAT

Section 59A, commonly referred to as the BEAT, imposes an additional tax on certain large corporate taxpayers that make “base erosion payments” (which include deductible payments and other categories of payments) to certain foreign related persons. The proposal would retain the general framework of the BEAT regime with several important modifications, including some modifications that would more closely align the BEAT with the administration’s Stopping Harmful Inversions and Ending Low-tax Developments (SHIELD) proposal. Read **KPMG Report: Analysis and observations of tax proposals in administration’s FY 2022 budget** [PDF 1.4 MB] (118 pages) for a detailed discussion of SHIELD.

The proposal also would align the BEAT more closely with the OECD’s work on Pillar Two, briefly summarized above.
The proposed changes generally would apply to tax years beginning after December 31, 2021, with one significant exception noted below.

The JCT has estimated that the proposal would raise approximately $24.863 billion over a 10-year period.

**Eliminate base erosion percentage test starting in 2024**

The BEAT applies to “applicable taxpayers.” An applicable taxpayer is a corporation (other than a regulated investment company (RIC), real estate investment trust (REIT), or S corporation) that has: (i) average annual gross receipts of at least $500 million for the three preceding tax years (the gross receipts test); and (ii) a base erosion percentage (BE%) for the tax year in excess of the applicable threshold (the BE% test). The applicable threshold for the BE% test generally is 3% but is decreased to 2% for taxpayers that are members of an affiliated group that includes a bank or a registered securities dealer.

The proposal would eliminate the BE% test for tax years beginning after December 31, 2023, while retaining (without modification) the gross receipts test.

**KPMG observation**

Eliminating the BE% test would significantly increase the scope of applicable taxpayers subject to the BEAT. In addition to increasing revenue, the elimination of the BE% test appears intended to move BEAT closer to the OECD’s Pillar Two proposal and the administration’s SHIELD proposal, both of which would apply without regard to the level of base erosion of a company. Instead, those proposals would apply to any corporation that is a member of a financial reporting group with worldwide gross revenue in excess of certain thresholds ($900 million under Pillar Two, and $500 million under SHIELD). While BEAT also has a gross receipts threshold, gross receipts for this test include only U.S. gross receipts (rather than global receipts). BEAT’s focus on U.S. as opposed to worldwide revenue, therefore, would seem to benefit large foreign-parented multinationals that would meet the global revenue thresholds for Pillar Two and the SHIELD but not the $500 million U.S. gross receipts threshold for the BEAT.

The BE% was most important to U.S. companies that faced a precipitous cliff if treated as an applicable taxpayer due to the unfavorable treatment of foreign tax credits under the current BEAT liability calculation. As discussed below, the proposal would remove this harsh treatment of U.S. groups that claim foreign tax credits.

**Modify BEAT liability computation**

The proposal would make several changes to the computation of an applicable taxpayer’s BEAT liability (the base erosion minimum tax amount).

Under current law, an applicable taxpayer’s BEAT liability for a tax year is the excess (if any) of: (i) the BEAT rate for the tax year multiplied by the taxpayer’s modified taxable income (MTI), over (ii) the taxpayer’s post-credit regular tax liability, with adjustments for certain credits (adjusted regular tax liability).

**Modify MTI calculation**

An applicable taxpayer determines MTI under current regulations by “adding back” to its regular taxable
income (i) its base erosion tax benefits for the year, and (ii) the “base erosion percentage” of any net operating loss (NOL) deduction allowed for the year.

The proposal would modify MTI to mean a taxpayer’s regular taxable income with the following adjustments: (1) base erosion tax benefits are determined without regard to certain base erosion payments, “including for purposes of determining the adjusted basis of property” acquired in exchange for a base erosion payment; (2) the base erosion payment portion of certain inventoryable costs is removed from cost of goods sold (COGS); and (3) the NOL deduction for the tax year is determined by (A) applying the 80% limitation to MTI (rather than taxable income), (B) determining the NOL for a year without regard to any deduction that is a base erosion tax benefit, and (C) making certain adjustments to take into account MTI rather than taxable income in the year to which a loss is carried for purposes of determining the amount of an NOL carryover that is absorbed. Additionally, “rules similar to the rules” of section 59(g) and (h) would apply unless the Secretary provides otherwise.

KPMG observation

The proposed change to MTI appears intended to increase MTI by the amount of base erosion tax benefits for the year arising from base erosion payments other than those related to COGS. The precise meaning of the language regarding the adjusted basis of property acquired as a result of a base erosion payment is unclear.

KPMG observation

Under current law, an applicable taxpayer with NOLs can have a BEAT liability for a year even if it makes no base erosion payments and has no base erosion tax benefits during the year. This is because the BE% of a taxpayer is determined based on the BE% of the taxpayer’s aggregate group, and the NOL deduction that is added back to MTI is based on the aggregate group’s BE% for the year the NOL arose. Consistent with the elimination of the BE% test, the proposal would determine the portion of an NOL deduction that must be added back to regular taxable income based solely on the taxpayer’s base erosion tax benefits embedded in the NOL; the base erosion tax benefits or BE% of the taxpayer’s aggregate group would not be taken into account. Additionally, consistent with the existing regulations, the proposal appears to take a vintage approach to determining the portion of an NOL that is comprised of base erosion tax benefits (i.e., that portion is determined based on the base erosion tax benefits in the year the NOL arose).

Section 172 generally limits the amount of an NOL that a taxpayer may deduct in a tax year to 80% of taxable income for the year. The proposal similarly limits the amount of an NOL deduction taken into account in determining MTI to 80% of MTI. This can be contrasted with current law under which the nominal amount of an NOL deduction for BEAT purposes is locked in based on the amount allowed for regular tax purposes, with the only BEAT adjustment being to apply the BE% for the year the NOL arose to haircut the NOL deduction.

KPMG observation

It is not clear from the proposal, staff summary, or technical explanation how the rules of section 59(g) and (h) would be reconfigured for MTI purposes. It appears, however, that these rules would apply to limit deductions, thereby increasing MTI relative to regular taxable income under certain
circumstances. For example, section 59(g) applies a tax benefit rule and section 59(h) applies limitations based on section 704(d) (disallowance of certain partnership losses), section 465 (disallowance of deductions for amounts not considered “at risk”), and section 1366(d) (S corporation losses limited to adjusted basis of stock and debt).

Expand scope of base erosion payments for certain indirect COGS

The proposal would create two new categories of base erosion payments with respect to certain amounts allocated and accounted for as part of a taxpayer’s inventoriable costs and COGS. First, any amount paid or accrued by the taxpayer to a foreign related party for indirect costs described in section 263A(a)(2)(B) that are required to be included in the taxpayer’s inventory costs under section 263A(a)(1)(A) would be a base erosion payment. For example, a taxpayer that pays a foreign affiliate a royalty for the right to produce and sell inventory in the United States would have to treat the royalty as a base erosion payment that is excluded from COGS for purposes of MTI.

Second, in the case of inventory that is acquired from a foreign related person, for purposes of computing MTI, COGS would be limited to the foreign related person’s direct costs plus indirect costs paid to a U.S. or unrelated person, or otherwise subject to U.S. tax. For purposes of this second category, the direct costs of a foreign related party that are paid to another foreign related party are taken into account only to the extent the taxpayer demonstrates that the costs are attributable to amounts paid or accrued (directly or indirectly) to a U.S. person or a person that is not related to the taxpayer.

Additionally, in lieu of calculating the foreign related party’s indirect costs that are paid to a U.S. or unrelated person, or otherwise subject to U.S. tax, the proposal includes a safe harbor (implemented by forthcoming time and manner regulations) that would treat such costs as equal to 20% of the total amount paid to the foreign related party for the acquisition of the inventory property. Accordingly, for inventory acquired from a foreign related person, MTI would be computed to include COGS for the foreign person’s direct costs plus the 20% safe harbor amount.

KPMG observation

Under current law, payments made to foreign related parties for the acquisition of inventory or that are otherwise treated as “inventoriable” costs recovered as COGS are not base erosion payments, except with respect to certain inverted groups. This is because expenses capitalized into inventory are not taken into account as a deduction but instead are taken into account as a reduction in gross receipts in computing gross income.

The proposed expansion of base erosion payments to include amounts that otherwise would be included in COGS thus marks a significant expansion of the scope of BEAT. The proposal also differs from the SHIELD proposal, which would effectively deny costs included in COGS by denying non-COGS deductions by reference to such costs. The mechanics of capitalization under section 263A and the regulations thereunder would not appear to matter; for example, many sales-based royalties are allocable solely to inventory that has been sold.

Additionally, with respect to the safe harbor, the technical explanation provides a different formulation than appears in the statute. The technical explanation suggests that the safe harbor would “treat as a base erosion payment 20% of the amount paid or incurred to [a] foreign related party for the acquisition of inventory.” The statutory text of the safe harbor, however, does not suggest a cap on the disallowed amount at 20%.
Changes to BEAT rate

Under current law, the BEAT rate generally is 5% for tax years beginning in calendar year 2018, 10% for tax years beginning after calendar year 2018 but before 2026, and 12.5% for tax years beginning after calendar year 2025.

The proposal would accelerate the increase to the 12.5% rate to apply to tax years beginning after December 31, 2023, and further increase the rate to 15% for tax years beginning after December 31, 2025.

KPMG observation

The proposal would both accelerate the scheduled rate increase and then further increase the top rate to 15%. Although the proposal, staff summary, and technical explanation do not mention the OECD’s work on Pillar Two, the 15% target rate for BEAT aligns with a Pillar Two global minimum tax rate of “at least” 15%.

Under current law, affiliated groups that include a bank or registered securities dealer are subject to a BEAT rate one percentage point higher than the generally applicable BEAT rate. The proposal retains this rule and extends the higher BEAT rate to banks and registered securities dealers that are applicable taxpayers, regardless of whether they are members of an affiliated group. The proposal also would amend the definition of bank to include foreign banks operating a U.S. branch and would amend the definition of affiliated group to include foreign corporations.

KPMG observation

The BEAT statute currently applies a higher rate to corporations that are members of an affiliated group that includes a bank or registered securities dealer, but the statute technically does not apply the higher rate to a bank or registered securities dealer that is not part of an affiliated group. The proposal would fix what appears to be an error in the original statute.

Changes to treatment of tax credits

The proposal would modify the treatment of tax credits in determining the BEAT liability. BEAT liability is based on a comparison of an applicable taxpayer’s MTI (multiplied by the applicable BEAT rate) to the taxpayer’s regular tax liability, reduced by all credits other than the research credit and a portion of three other general business tax credits (the low-income housing credit, renewable electricity production credit, and energy credit).

The proposal would amend the BEAT liability calculation to compare the taxpayer’s MTI (multiplied by the BEAT rate) to its pre-credit regular tax liability with no downward adjustment for any credits.

KPMG observation

Removing the unfavorable treatment of tax credits (other than the few currently favored credits) by comparing MTI to a taxpayer’s pre-credit rather than post-credit regular tax liability may reduce or eliminate the BEAT liability of taxpayers with significant credits, particularly U.S. multinationals with
In addition to these favorable changes, the proposal would modify the rules in section 38(c)(1) to take into account a taxpayer’s BEAT liability in determining the amount of general business credits the taxpayer is allowed for the year.

**KPMG observation**

The proposed changes to section 38 would generally increase the amount of allowable general business credits for BEAT taxpayers. Under section 38(c), the amount of the credit allowed for general business credits is limited (in part) by the taxpayer’s “net income tax” for the year, which currently is a taxpayer’s regular tax liability plus the tax imposed by section 55 (which no longer applies to corporations) reduced by certain credits. Accordingly, adding section 59A taxes to the definition of net income tax would expand the taxpayer’s base for determining allowable general business credits.

**Exempt payments subject to U.S. tax or sufficient foreign tax from the definition of base erosion payment**

The proposal would exclude an amount from the definition of a base erosion payment if U.S. tax is imposed “with respect to such amount.” The determination of the amount not treated as a base erosion payment would be determined by applying “rules similar to” pre-TCJA section 163(j)(5).

**KPMG observation**

The technical explanation states that this exemption applies to “[p]ayments that are subject to Federal income tax by either the payor or payee, . . . without regard to whether the income related to such payments was eligible for a reduced rate of tax.” The technical explanation further states that the exception applies to payments (1) included in GILTI or FDII without regard to the section 250 deduction, (2) subject to U.S. withholding tax, or (3) taxable as income effectively connected with a U.S. trade or business. Presumably, this would also include subpart F inclusions. It is unclear what FDII transactions the technical explanation anticipates would be relevant to this rule.

There is no explanation in the proposal, staff summary, or technical explanation of how rules similar to the rules in former section 163(j)(5) would be used to determine the amount of a payment that would be considered subject to U.S. tax. Under the current statute and regulations, a deduction with respect to a base erosion payment is not treated as a base erosion tax benefit if the payment to the foreign related party is subject to full 30% gross basis taxation under section 871 or section 881 and tax is withheld under section 1441 or section 1442. Sections 871(a) and 882(a) generally impose a 30% gross basis tax on the U.S. source fixed or determinable annual or periodical (“FDAP”) income (e.g., dividends, interest, royalties) of nonresident alien individuals and foreign corporations. If a base erosion payment is subject to a reduced rate of gross basis tax under an income tax treaty, the amount of the associated base erosion tax benefit is equal to the reduction in tax under the treaty by applying rules similar to the rules in former section 163(j)(5). The proposal would eliminate this special rule for payments subject to gross basis tax because payments described in this rule would be exempt under the new broader proposal for payments subject to U.S. tax—with such exemption again being subject to rules similar to former section 163(j)(5). Therefore, it appears that, as under current law, FDAP payments would not be fully exempt under
the proposal if subject to a reduced rate of withholding.

While not entirely clear from the proposed legislative text, the technical explanation indicates that amounts paid to a CFC that are included in a U.S. shareholder’s computation of GILTI are not treated as base erosion payments, regardless of whether the payments are subject to a reduced rate of U.S. tax because of the section 250 deduction. Combined with the favorable changes to the treatment of foreign tax credits and other credits, this exception means that many U.S. multinationals would not have a BEAT liability under the proposal.

Although the technical explanation supports the view that any payment that is included in the GILTI computation should be exempt from BEAT, the proposed legislative text would require U.S. tax to be imposed “with respect to such amount,” potentially calling into question situations when a taxpayer does not owe tax with respect to a payment due to unrelated tested losses or the deemed tangible income return. This rule can be contrasted with the special rule for payments to CFCs under section 267(a)(3)(B), which allows the payor a deduction “only to the extent an amount attributable to such item is includible” in the gross income of a U.S. shareholder of the CFC in the current tax year.

The proposal also would provide an exception to the definition of base erosion payment for certain payments that are subject to a sufficient rate of foreign tax. Under this exception, an amount is not treated as a base erosion payment if the taxpayer establishes to the satisfaction of the Secretary that the amount was subject to an effective rate of foreign income tax—determined in accordance with section 904(d)(2)(4)—that is not less than the applicable BEAT rate for the year in which the amount is paid or accrued. The proposal would allow taxpayers to determine the effective rate of foreign income tax based on the applicable financial statements (as defined in section 451(b)(3)), unless the Secretary provides otherwise. The proposal also would provide Treasury with broad regulatory authority to issue regulations determining the effective tax rate (“ETR”) on an amount, including by recharacterizing transactions as necessary to carry out or prevent avoidance of this rule.

KPMG observation

By including an ETR test in BEAT, the proposal would go a long way to align BEAT with the goal of targeting low-tax operations, consistent with SHIELD and Pillar Two. However, whereas SHIELD and Pillar Two would test the ETR on a jurisdictional basis, the basis for the proposal’s ETR testing is less clear and is subject to development in future regulations. The base rule appears focused on individual payments; however, the ability to use financial statements appears to (at least) allow the determination of the ETR at the entity level, and possibly at a jurisdictional level. Moreover, while the SHIELD proposal would provide authority to the Secretary to issue regulations carving out certain payments if the group is subject to a sufficiently high rate of tax on a jurisdictional basis, it is not clear whether the Ways and Means proposal’s grant of regulatory authority would allow Treasury categorically to exclude payments to certain jurisdictions for BEAT purposes.

Modify statutory SCM exception

The proposal would provide that the total services cost of payments that are eligible for the services cost method (“SCM”) are excluded from the definition of base erosion payment as long as the requirements for the SCM exception under section 482 are satisfied (without regard to the business judgment rule).
KPMG observation

The proposal appears to codify the SCM exception in the BEAT regulations without substantive change.

KPMG observation

This revenue estimate is relatively modest in comparison to SHIELD, which the administration estimated would raise $390 billion in revenue over nine years. Overall, it appears the proposal’s drafters are balancing the need to raise revenue with a desire to make the BEAT function in a way that is both fairer to taxpayers and better aligned with global tax reform initiatives to reduce base erosion. Thus, the proposal would raise revenue, e.g., by eliminating the BE% test from the applicable taxpayer determination and increasing the BEAT rate, but it would also spend revenue to restore the full value of credits and exempt certain payments subject to U.S. tax or sufficient rates of foreign tax.

Section 163(n), section 163(j) and section 163(o)

Limitations on deduction for interest expense

This proposal, which is very similar to a 2017 House proposal that was considered but ultimately dropped from TCJA, would add new section 163(n), to potentially limit the amount of deductible interest expense of a “specified domestic corporation” that is a member of any “international financial reporting group.” The limitation, which is described in detail below, is based largely on data from financial statements or books and records and is generally determined by allocating the group’s net interest expense to the U.S. members of the group based on the U.S. members’ share of the group’s earnings. This proposed limitation on deductions for interest expense would apply in addition to the general disallowance of interest expense under current section 163(j). Whichever provision, new section 163(n) or existing section 163(j), would deny the greater amount of interest deductions would apply to the U.S. members.

The JCT has estimated the proposal would raise approximately $34.813 billion over a 10-year period.

KPMG observation

Unlike the excess interest proposal contained in the Green Book, which was targeted at U.S. subsidiaries of foreign parented groups, this provision would also apply to U.S. multinationals. As such, a domestic taxpayer’s leverage would be compared to all foreign members of the group, whether the foreign members are subsidiaries of the taxpayer or are sister entities under a foreign parent. Foreign corporations with effectively connected income (ECI) are treated as domestic corporations with respect to earnings, interest income, interest expense, and any other amounts, which are effectively connected with the conduct of a U.S. trade or business. Presumably, under the proposal, a foreign corporation with ECI (and non-ECI) should be treated as both a foreign corporation and domestic corporation, but that is not clear from the proposed statutory language and the JCT technical explanation does not provide more clarity. Treasury is granted broad
regulatory authority to address the treatment of foreign corporations with ECI.

KPMG observation

The proposal presumably relies on 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.

New section 163(n) would limit a “specified domestic corporation’s” current deduction for interest expense to an amount equal to the “allowable percentage” times 110% of the specified domestic corporation’s net interest expense as determined for U.S. tax purposes. The allowable percentage is the domestic corporations “allocable share” of the group’s reported net interest expense (“GRNIE”) divided by the domestic corporation’s reported net interest expense (“DCRNE”). The allocable share is the product of GRNIE times the ratio of (i) the domestic corporation’s earnings before interest, taxes, depreciation and amortization (“EBITDA”) to (ii) the group’s EBITDA, both as determined for that year and as reported in the financial statements. As a formula, the allowable percentage is \( \frac{GRNIE \times (\text{domestic corporation's EBITDA}/ \text{group EBITDA})}{DCRNIE} \).

KPMG observation

For example, 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, so the ratio of U.S. to group EBITDA is 50%. The foreign parent’s only borrowing is $100 at 4%, which is on-lent to the U.S. subsidiary at 5%. Absent the proposal, the U.S. subsidiary would deduct the full $5 of interest expense for U.S. tax purposes.

The U.S. subsidiary’s net interest expense for financial reporting purposes is $5, and the group’s net interest expense reported on the consolidated financial statements is $4 (the $5 of intercompany interest income and expense are eliminated in consolidation). The U.S. subsidiary’s allocable share of the group’s $4 of net interest expense is 50% (its share of EBITDA) or $2, and the U.S. subsidiary’s allowable percentage is 40% ($2/$5) (the ratio of its allocable share of the group’s net interest expense to the U.S. subsidiary’s reported net interest expense).

In this case, the U.S. subsidiary’s deduction is limited to $2.20, consisting of 110% of the $5 of interest expense, or $5.50, multiplied by 40%, the allowable percentage. Thus, in this example, $2.80, calculated as $5.00-$2.20, would be disallowed. The disallowed interest would be carried forward as described below.

KPMG observation

The current Green Book proposal did not provide for the 10% “uptick”—that is, it simply multiplied the U.S. corporation’s interest expense by the allowable percentage. The 10% uptick is a feature from the TCJA House proposal for section 163(n).
Directly earned foreign income, such as income earned through non-hybrid foreign branches, foreign royalties, and export sales, is included within the specified domestic corporation’s EBITDA but adjusted to conform to the amounts reflected in the group’s financial statements. The treatment of items of a hybrid foreign branches is less clear, but it appears they are included in a U.S. member’s EBITDA and net interest expense determinations on the basis that they are items “of” the U.S. member for U.S. tax purposes and are reflected on the books and records of the group (even if not on the books and records of the U.S. member). In contrast, by apparently not giving U.S. group member’s credit for subpart F or GILTI inclusions from a CFC, the provision systematically disallows domestic interest expense allocable to CFC income. This may in some circumstances lead to what could be viewed as significant over-taxation that is difficult to justify. For example, if a CFC earns only subpart F income that is not subject to any foreign tax, there is no effective difference in (pre-interest expense) taxation of those earnings when compared to a direct investment in its underlying assets by its U.S. shareholder. Nevertheless, under proposed section 163(n), a proportionate amount of the U.S. shareholder’s interest expense would be disallowed merely because the investments were made through the CFC instead of directly.

KPMG observation

It is conceivable that 163(n) could be viewed as applicable to CFCs by reason of Reg. § 1.952-2 and the directive to compute the taxable income of a CFC for subpart F and GILTI purposes as if the CFC were a domestic corporation. Such a reading would, however, seem very much contrary to the overall structure and purposes of the proposal. In addition, the IRS and Treasury have indicated that they are considering guidance that would eliminate or at least limit the scope of that regulatory directive in the context of provisions that specifically apply only to domestic corporation.

A “specified domestic corporation” is defined by requirements and exceptions. For the requirements, the domestic corporation must be a member of an international financial reporting group, which is any group of two or more entities that in the current year:

- Includes at least
  - One foreign corporation that is engaged in a trade or business in the United States, or
  - At least one domestic (U.S.) corporation and one foreign corporation; and

- Are included in the same applicable consolidated financial statement for that year.

A “consolidated financial statement” generally means for this purpose a statement made on the basis of generally accepted accounting principles (“GAAP”), international financial reporting standards (“IFRS”), or other comparable method of accounting and which is provided to the U.S. Securities and Exchange Commission, to shareholders or creditors, or to other governmental agencies for non-tax purposes. The proposal cross-references section 451(b)(3) for this definition.

The proposal gives the Secretary authority to address several issues, including coordination with section 163(j)(4) and the ability to include or exclude any corporation as a member of any international financial reporting group. Specifically, Treasury is given authority to provide an election to allow other 20% owned corporations to be treated as part of the international financial reporting group.
The definition of international financial reporting group in the proposal contrasts with the TCJA House proposal of section 163(n), which would have required an international financial reporting group to have average gross receipts for three-year period ending in the current year of $100 million in order for the rule to apply.

Unlike under the Green Book proposal, this proposal does not contain a carveout for financial services entities. In any event, many financial services entities have net interest income rather than net interest expense, diminishing the significance of the omission.

For the exceptions, a specified domestic corporation does not include a domestic corporation that (i) is an S corporation, REIT, RIC, or a small business under section 163(j)(3) or (ii) that has a de minimis amount of net interest expense. A small business under section 163(j)(3) is a corporation whose single employer group (as determined under section 448(c)(2)) has average annual gross receipts over the three-year period ending with the current tax year of $25M or less. A domestic corporation has de minimis net interest expense if its average net interest expense as determined for U.S. tax purposes does not exceed $12M. For purposes of this determination, all domestic corporations in the international financial reporting group are aggregated and the average net interest expense is determined over the three tax years ending with the current tax year.

In addition, proposed section 163(n) does not apply if the international financial reporting group has zero or negative EBITDA. If, however, the group has positive EBITDA and the specified domestic corporation has zero or negative EBITDA, the allowable percentage is zero, meaning that the allowable interest expense is zero.

Although the interaction of these rules would appear to allow an interest expense deduction (which may ultimately be reflected in a net operating loss) for a specified domestic corporation with negative EBITDA if it is part of a group with overall negative EBITDA, this would generally be the result only if the corporation is not subject to 163(j) (for example, if the interest relates to an electing real property trade or business).

The proposal would not allow excess limitation to be carried forward.

In further contrast to this proposal, the Green Book contemplates an excess limitation carryforward (but did not specify a carryforward period). The TCJA House version of proposed section 163(n) did not include an excess limitation carryforward.

Five-year carryforward limit on disallowed business interest expense
Under current law, disallowed business interest expense, including excess business interest expense, may be carried forward indefinitely. As noted above, section 163(n) 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. Under a proposed new section 163(o), interest expense paid or accrued in a tax year beginning after December 31, 2021, that is disallowed under either section 163(j) or 163(n) could not be carried forward past the fifth tax year following the tax year in which such interest was paid or accrued. For purposes of this rule, interest expense would be treated as allowed as a deduction on a “first-in, first-out basis.” It appears that disallowed business interest expense under section 163(j) that is carried forward from tax years ending on or prior to December 31, 2021, would not be subject to the five-year carryforward limitation. However, it is not clear that this exception for prior year disallowed business interest expense would apply to excess business interest expense that is treated as paid or accrued by a partner on January 1, 2022, pursuant to a proposed transition rule (see below).

KPMG observation

The proposal’s five year “use it or lose it” approach with respect to disallowed business interest expense may have a substantial impact on the ability for taxpayers to deduct business interest expense and the impact on a taxpayer’s financial statements should be considered. In particular, the depreciation, amortization, and depletion addback to adjusted taxable income expires for tax years beginning on or after January 1, 2022, which would further limit the ability for taxpayers to deduct carryforward business interest expense just as the five-year carryforward limitation would become effective. As such, the ability to be excepted from section 163(j) may be more important, resulting in an increased focus on eligibility for the real property, regulated utility, and farming exceptions.

Application of section 163(j) to partnerships and S corporations

Treatment of partnership level business interest expense

Under current law, section 163(j) is applied to partnerships at the partnership level. As such, a partnership calculates its section 163(j) limitation based on the partnership’s business interest expense, adjusted taxable income, and business interest income. To the extent that business interest expense of a partnership is subject to a limitation under section 163(j), the disallowed business interest expense (“excess business interest expense”) is allocated to each partner. Excess business interest expense allocated to a partner is treated as business interest expense paid or accrued by the partner in a succeeding tax year to the extent the partner is allocated excess taxable income or excess business interest income from the same partnership. A partner computes the partner’s own section 163(j) limitation with respect to business interest expense incurred by the partner, including excess business interest expense that is treated as paid or accrued by the partner, without regard to the partner’s distributive share of the partnership’s items of income, gain, deduction, or loss and may only include the partner’s allocable share of excess taxable income from the partnership in the partner’s own adjusted taxable income.

The proposal would apply section 163(j) at the partner level rather than the partnership level.

KPMG observation

The proposal would fundamentally change the application of section 163(j) to partnerships by
adopting an “aggregate approach,” thereby applying section 163(j) solely at the partner level. Business interest expense of a partnership, business interest income of a partnership, and all partnership items that comprise adjusted taxable income would presumably be passed up to the partner to be taken into account at the partner level in computing the partner’s section 163(j) limitation. Partnerships would no longer compute a partnership level section 163(j) limitation, and concepts such as excess business interest expense, excess taxable income and excess business interest income would no longer be relevant or applicable. The proposal stands in marked contrast to a September 2021 discussion draft released by Senate Finance Committee Chairman Ron Wyden (D-OR) that would adopt an even more stringent entity approach than what is contained in the current rules.

KPMG observation

The proposal would likely eliminate much of the complexity with respect to the application of section 163(j) to partnerships. However, under the proposal, a partner would need to track (through tiers, if necessary) all items that are relevant in computing its section 163(j) limitation at the partner level. This includes partnership level business interest expense, business interest income, and all items that comprise adjusted taxable income. In addition, items that are relevant for the computation of adjusted taxable income, such as depreciation or amortization, would need to be separately stated by the partnership.

Partners would also continue to require information to allocate the partner’s business interest expense between excepted and non-excepted trades or businesses. However, it is not clear whether the characterization of business interest expense of a partnership as properly allocable to an excepted or non-excepted trade or business would continue to be determined at the level of the partnership holding the trade or business or at the partner level when the section 163(j) limitation would ultimately apply.

In addition, although not entirely clear, the small business exemption would presumably be applied at the partner level.

KPMG observation

Tracing would still be required to determine whether interest expense incurred by a partnership is properly treated as business interest expense as opposed to investment interest expense. Currently there is uncertainty as to the proper characterization of partnership interest expense with respect to debt incurred to fund a “debt financed distribution.” Under existing guidance from the IRS and Treasury, including Notice 89-35, such interest is generally traced to the partner’s use of the debt financed distribution proceeds unless an alternative rule is applied to trace such interest to partnership expenditures. The current entity approach to the application of section 163(j) to partnerships may conflict with the aggregate approach that has generally been applied to tracing interest expense incurred in connection with a debt financed distribution. The application of the aggregate approach to section 163(j) would make the continued application of existing guidance related to debt financed distributions more certain.
KPMG observation

The change for partnerships and partners to an aggregate approach for computing the interest limitation would likely result in complexities from a state tax perspective. Given that certain states adopt fixed conformity to a prior version of the Code and would not adopt this change unless action was taken by the state’s legislature to adjust conformity, some states may continue to use the limitation rules established by the TCJA. For taxpayers filing in that type of state, this would require the preparation of additional computations and the tracking of excess items for partners, as these values would be needed to prepare the state tax base computations, even though the federal computation changed and no longer required tracking of these values.

Transition rule

The proposal includes a transition rule for partners that have been allocated excess business interest expense. For tax years beginning after December 31, 2021, any outstanding excess business interest expense that was allocated to a partner would be treated as paid or accrued by the partner in such tax year. It is not clear whether such paid or accrued excess business interest expense would be subject to the five-year carryforward limitation.

KPMG observation

The treatment of excess business interest expense as paid or accrued by a partner may be helpful, particularly for partners invested in partnerships that would otherwise not have generated excess taxable income (such as partnerships that made a real property trade or business election after a prior year allocation of excess business interest expense to its partners). However, if the freed up excess business interest expense would be subject to the five-year carryforward rule (discussed above), partners with large amounts of excess business interest expense (which partners may have accumulated over four years) may have difficulty deducting the entire amount of the freed up excess business interest expense within five years.

Application to S corporations

The proposal would also apply an aggregate approach to S corporations, treating them in the same manner as partnerships. Thus, S corporations would no longer compute an entity level section 163(j) calculation. Instead, the S corporation’s business interest expense, business interest income, and items that comprise adjusted taxable income would pass up to the S corporation’s shareholders to be taken into account at the shareholder level in computing the shareholder’s section 163(j) limitation.

KPMG observation

As is the case with partnerships, the proposal would fundamentally change the application of section 163(j) to S corporations by adopting an “aggregate approach,” thereby applying section 163(j) solely at the shareholder level. Thus, many of the considerations discussed above with respect to partnerships would apply to S corporations.
Proposals related to the taxation of foreign fossil fuel income

Consistent with the Green Book, the proposal would make two significant changes with respect to foreign oil and gas extraction income (“FOGEI”) and foreign oil related income (“FORI”). First, the proposal would expand the definitions of FOGEI and FORI for purposes of the special limitation applicable to certain foreign taxes related to foreign oil and gas income to include income from oil shale and tar sands activity. It would also repeal the exemption under current law for FOGEI (including properly allocable deductions) from determining a CFC’s tested income and tested loss for purposes of GILTI. If finalized, both changes would apply to tax years of foreign corporations beginning after December 31, 2021, and to tax years of United States shareholders in which or with which such tax years of foreign corporations end.

The proposal would amend section 901(n) to codify 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 when 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 would be the lesser of the foreign dual capacity levy rate or the U.S. corporate rate, proposed to be a graduated rate between 18% and 26.5% and subject to clawback.

Consistent with the 2021 Green Book proposal, the amendment would codify the safe harbor method for a dual capacity taxpayer to determine the portion of a foreign levy paid for a specific economic benefit, effectively eliminating the facts and circumstances method. Additionally, the new amendment follows prior legislative proposals recently introduced in the House and Senate, clarifying that 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. This treatment departs from existing regulations that would allow creditable foreign taxes based on the U.S. rate if the local jurisdiction does not have a generally applicable corporate income tax. Additionally, although the 2021 Green Book proposal provided that a 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, the amendment does not include any treaty-specific relief. It should be noted this is a departure from Senator Wyden’s most recently proposed legislation that maintained the exception in the case of a treaty obligation of the United States.

The amendment to section 901(n) 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). Both the Green Book and Senator Wyden’s most recently introduced version of dual capacity taxpayer rule changes described codification of the safe harbor rule in connection with other reforms to the taxation of fossil fuels and limited the change to “major integrated oil companies” within the meaning of section 167(h)(5). However, the proposal makes no such distinction and appears to apply to all taxpayers. 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 amendment could be significant to a taxpayer operating in a different industry to the extent levies imposed on such taxpayer include an amount with respect to a specific economic benefit.

KPMG observation

The JCT has estimated that the proposal would raise approximately $5.66 billion over a 10-year period. This amount is significantly more than Treasury’s estimate of the Green Book dual capacity taxpayer proposal ($1.43 billion) and may reflect the treatment of treaty jurisdictions under the proposal.

KPMG observation

Recently proposed amendments to the dual capacity taxpayer rules included a reference to regulations in order to determine the extent to which an amount paid or accrued by a dual capacity taxpayer exceeds the relevant foreign country’s generally applicable income tax, while the proposal does not reference regulations at all. This may be an acknowledgment that Treasury and the IRS are expected to include changes to the dual capacity taxpayer regulations that are consistent with the amendment and the specific request for comments on whether such changes were necessary in the preamble to proposed foreign tax credit regulations announced in November 2020.
The proposal’s effective date language provides that the amended dual capacity taxpayer rules would “apply to tax years of foreign corporations beginning after December 31, 2021, and to tax years of United States shareholders in which or with which such tax years of foreign corporations end.” The language reads as if the provision would apply only to controlled foreign corporations, although nothing in the substantive rules of the provision is so limited.

The JCT’s “revenue estimate” of the proposal suggests that the proposal would be effective for taxes paid or accrued in tax years beginning after the date of enactment. Nevertheless, the JCT technical explanation accompanying the proposal tracks the bill’s language.

**Domestic international sales corporation (DISC)**

**Clarification of treatment of DISC gains and distributions of certain foreign shareholders**

A U.S. corporation that meets certain requirements, can elect to be treated as an interest charge domestic-international sales corporation (IC-DISC). An IC DISC is ordinarily not subject to tax. Rather, its shareholders are generally taxed upon distribution of profits from the IC DISC. The failure of the IC DISC to make a timely distribution results in an interest charge to the IC DISC.

Under current section 996(g), distributions to a foreign shareholder of an IC DISC are treated as distributions which are effectively connected with the conduct of a trade or business conducted through a permanent establishment of such shareholder. The bill would amend 996(g) to change the phrase “permanent establishment of such shareholder” to “permanent establishment deemed to be had by such shareholder.”

The JCT has estimated that the proposal would raise approximately $915 million over a 10-year period.

**KPMG observation**

This change appears to be intended to clarify that a taxpayer need not have an actual permanent establishment for the distributions of an IC DISC to be taxable to its foreign shareholder.

**International glossary**

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>BE%</td>
<td>base erosion percentage</td>
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<tr>
<td>BEAT</td>
<td>base erosion anti-abuse tax</td>
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<tr>
<td>BEPS</td>
<td>base erosion and profit shifting</td>
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<tr>
<td>CFC</td>
<td>controlled foreign corporation</td>
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<tr>
<td>COGS</td>
<td>cost of goods sold</td>
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<tr>
<td>DEI</td>
<td>deduction eligible income</td>
</tr>
<tr>
<td>DRD</td>
<td>dividend received deduction</td>
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<tr>
<td>ETR</td>
<td>effective tax rate</td>
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<tr>
<td>ETI</td>
<td>extra-territorial income</td>
</tr>
<tr>
<td>Abbreviation</td>
<td>Description</td>
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<td>--------------</td>
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<tr>
<td>EBITDA</td>
<td>earnings before interest, taxes, depreciation and amortization</td>
</tr>
<tr>
<td>FDDEI</td>
<td>foreign-derived deduction eligible income</td>
</tr>
<tr>
<td>FHTP</td>
<td>foreign harmful tax practices</td>
</tr>
<tr>
<td>FOGEI</td>
<td>foreign oil and gas extraction income</td>
</tr>
<tr>
<td>FORI</td>
<td>base erosion anti-abuse tax</td>
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<tr>
<td>FPHCI</td>
<td>foreign personal holding company income</td>
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<tr>
<td>FSC</td>
<td>foreign sales corporation</td>
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<tr>
<td>FTC</td>
<td>foreign tax credit</td>
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<tr>
<td>GAAP</td>
<td>Generally Accepted Accounting Principles</td>
</tr>
<tr>
<td>G7</td>
<td>The Group of Seven is an intergovernmental organization consisting of Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.</td>
</tr>
<tr>
<td>GILTI</td>
<td>global intangible low-taxed income</td>
</tr>
<tr>
<td>IC-DISC</td>
<td>interest charge domestic-international sales corporation</td>
</tr>
<tr>
<td>IIR</td>
<td>income inclusion rule</td>
</tr>
<tr>
<td>IFRS</td>
<td>international financial reporting standards</td>
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<tr>
<td>JCT</td>
<td>Joint Committee on Taxation</td>
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<tr>
<td>MTI</td>
<td>modified taxable income</td>
</tr>
<tr>
<td>NOL</td>
<td>net operating loss</td>
</tr>
<tr>
<td>NOCD</td>
<td>non-ordinary course distribution rule</td>
</tr>
<tr>
<td>ODL</td>
<td>overall domestic loss</td>
</tr>
<tr>
<td>OECD</td>
<td>Organization for Economic Cooperation and Development</td>
</tr>
<tr>
<td>OFL</td>
<td>overall foreign loss</td>
</tr>
<tr>
<td>PFIC</td>
<td>passive foreign investment company</td>
</tr>
<tr>
<td>Pillar One</td>
<td>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.</td>
</tr>
<tr>
<td>Pillar Two</td>
<td>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.</td>
</tr>
<tr>
<td>PTEP</td>
<td>previously-taxed earnings and profits</td>
</tr>
<tr>
<td>QBAI</td>
<td>qualified business asset investment</td>
</tr>
<tr>
<td>QEF</td>
<td>Qualified electing fund</td>
</tr>
<tr>
<td>R&amp;D</td>
<td>research &amp; development</td>
</tr>
<tr>
<td>REIT</td>
<td>real estate investment trust</td>
</tr>
<tr>
<td>RIC</td>
<td>regulated investment company</td>
</tr>
<tr>
<td>SCM</td>
<td>services cost method</td>
</tr>
<tr>
<td>SFC</td>
<td>Specified investment company</td>
</tr>
<tr>
<td>SHIELD</td>
<td>stopping harmful inversions and ending low-tax developments</td>
</tr>
<tr>
<td>SLI</td>
<td>separate limitation income</td>
</tr>
<tr>
<td>SLL</td>
<td>separate limitation loss</td>
</tr>
</tbody>
</table>
Additional revenue-raising proposals

Increase in corporate tax rate

In 2017, with the enactment of the TCJA Congress imposed a flat 21% tax rate on the taxable income of C corporations. The TCJA repealed the prior graduated C corporation income tax rates, including the prior maximum rate of 35%.

The proposal would reinstate a progressive corporate tax rate structure, as follows:

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Tax rate (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not over $400,000</td>
<td>18</td>
</tr>
<tr>
<td>Over $400,000 but not over $5,000,000</td>
<td>21</td>
</tr>
<tr>
<td>Over $5,000,000</td>
<td>26.5</td>
</tr>
</tbody>
</table>

The proposal also includes a graduated rate clawback provision similar to pre-TCJA law, that would increase a C corporation’s tax liability by the lesser of (i) 3% of the corporation’s taxable income in excess of $10,000,000, or (ii) $287,000. This clawback provision effectively would apply a marginal corporate tax rate of 29.5% on a C corporation’s taxable income in excess of $10,000,000 but below $19,566,667, and would result in a C corporation with income in excess of $19,566,667 being subject to an effective rate of 26.5% on all of its taxable income.

The proposal would exclude personal service corporations (“PSCs”) from the graduated corporate tax rates, thus subjecting them to a flat corporate tax rate of 26.5% on all taxable income.

The new corporate rate would be effective for tax years beginning after December 31, 2021.

In addition, the legislation would increase the 65% dividends received deduction ("DRD") (for dividends from 20% owned corporations) to 72.5% and the 50% dividends received deduction (for dividends from less than 20% owned corporations) to 60%, effective for tax years beginning after December 31, 2021.

KPMG observation

A C corporation that utilizes a fiscal year would appear to be subject to a blended rate under section 15 for its tax year that begins before and ends after the December 31, 2021 effective date. Section 15 provides special rules (and a pro rata methodology) for determining how certain changes in the rate of tax apply to a taxpayer whose tax year straddles the effective date of the rate change.

Although the proposed corporate rate increase would not restore the maximum corporate rates to the 35% rate applicable prior to enactment of (TCJA), it does represent a material increase from the current 21% maximum rate.
The maximum corporate rate of 26.5% in the proposal is lower than the 28% corporate rate that was included in the Biden Administration’s tax proposals as set forth in the [General Explanation of the Administration’s Fiscal Year 2022 Revenue Proposals (the “Green Book”).]

The 26.5% rate is also substantially lower than the highest marginal rate applicable to individuals under current law (which is proposed to increase under the bill). This could have the effect of continuing to incentivize the generation of income through a C corporation structure if earnings are expected to be retained and therefore not subject to a second level of tax at the shareholder level through dividend distributions (although we note that the accumulated earnings and personal holding company taxes can apply to retentions of income in corporate solution).

The change in effective rates can be expected to affect the value of certain tax attributes, such as carryovers of net operating losses, capital losses, and disallowed business interest expense, and can be expected to affect cash tax models used in the context of M&A transactions.

The corporate rate increase may affect choice-of-entity decisions for some business entities. The 26.5% rate differs from the effective rate for domestic business income of an individual earned through passthrough entities after giving effect to the 20% deduction under section 199A, diminished as that is by a separate proposal in the legislation. Also, certain income from business activities of passthrough entities would still be taxed at the individual rates, for which the legislation would impose a maximum rate of 39.6%.

The proposed legislation would set the PSC tax rate to the maximum corporate tax rate of 26.5% on all taxable income. Generally, a professional service corporation is a C corporation (i) substantially all of the activities of which consist of the performance of services in fields such as accounting, health, law, etc., and (ii) with respect to which employees performing services for the corporation in the identified fields own, directly or indirectly, substantially all of its stock.

The proposal also departs from the Green Book proposals by providing for an increase in the DRD. This proposed change would maintain a rough parity between the maximum effective corporate tax rate imposed on dividends subject to the DRD before and after the proposed change to the corporate tax rate. For example, prior to the proposed legislation, a $100 dividend received by a corporate taxpayer subject to a 21% tax rate and eligible for a 65% DRD would generally have resulted in ($100 * (1 – 65%)) * 21%, or $7.35 of tax. Under the proposed legislation, the same dividend would generally result in ($100 * (1 – 72.5%)) * 26.5%, or $7.29 of tax, at the maximum corporate tax rate.

The proposed legislation does not include a minimum tax on book earnings of large corporations. The Green Book proposals would have included a 15% minimum tax on the worldwide book income of corporations with income in excess of $2 billion.

The JCT has estimated that the corporate tax rate increase would raise approximately $540 billion over a 10-year period.

Other business tax proposals

Credit for clinical testing of orphan drugs limited to first use or indication

Current law provides a 25% business tax credit for qualified clinical testing expenses incurred in testing
of certain drugs for rare diseases ("orphan drugs"). Qualified clinical testing expenses are costs paid or incurred to test an orphan drug after the drug has been approved for human testing by the Food and Drug Administration (the "FDA") but before the drug has been approved for sale by the FDA. A rare disease or condition is defined as one that (1) affects fewer than 200,000 persons in the United States, or (2) affects more than 200,000 persons, but for which there is no reasonable expectation that businesses could recoup the costs of developing a drug for such disease or condition from sales in the United States of the drug. Amounts included in computing the credit are excluded from the computation of the research credit and no deduction is allowed for the portion of otherwise allowable qualified clinical testing expenses equal to the amount of the orphan drug credit allowed for the tax year.

The proposal would limit the credit to expenses related to the first use or indication for an orphan drug as designated under section 526 of the Federal Food, Drug, and Cosmetic Act. The proposal also provides that clinical testing expenses for any drug that has received a marketing approval for any use or indication (either for use in rare disease or condition or non-rare disease or condition) do not qualify for the credit.

The proposed amendments to the orphan drug credit would apply to tax years beginning after December 31, 2021.

The JCT has estimated this proposal would increase revenue by approximately $2.7 billion over the 10-year budget window.

**Modifications to treatment of certain losses**

Current law generally allows taxpayers who own securities issued by a corporation to claim a worthless stock loss in the year in which the securities have become wholly worthless. In general, for this purpose a “security” includes a share of stock in a corporation, a right to subscribe for a share of stock, and a debt instrument issued by a corporation with interest coupons or in registered form.

In general, worthlessness is established through an identifiable event, or by a closed and completed transaction. Section 165(g)(1) provides that such a loss is treated as a loss from the sale or exchange, on the last day of the tax year, of a capital asset. For a domestic corporation, the loss on worthlessness of the stock or securities issued by a subsidiary corporation can be ordinary in character if the domestic corporate holder directly owns stock in the subsidiary that represents 80% or more of the total vote and value of the subsidiary’s stock and more than 90% of the total historical gross receipts of the subsidiary were not from certain passive sources.

Current law also provides that a shareholder of a liquidating corporation recognizes gain or loss on its receipt of assets from the liquidating corporation in complete liquidation, although a complete liquidation can qualify for tax-free treatment if the shareholder is a corporation that owns stock in the liquidating corporation that represents 80% or more of the total vote and value of the liquidating corporation’s stock. Generally, a complete liquidation requires shareholders of each class of stock in the liquidating corporation to receive at least a partial payment in exchange for their stock. As a result, a corporation that is underwater (i.e., a corporation whose liabilities exceed the aggregate fair market value of its assets) is unable to undertake a complete liquidation.

The proposal has a number of distinct elements:

First, the proposal, if enacted, would accelerate the timing of a worthless securities loss under section 165(g)(1) by treating the loss as a loss resulting from the sale or exchange of a capital asset at the time of the identifiable event establishing worthlessness (rather than on the last day of the tax year).

Second, the proposal would provide that a loss resulting from worthless partnership interest is treated as
a loss arising from the sale or exchange of partnership interest, at the time of the identifiable event establishing the worthlessness, subject to section 741. Thus, the character of the loss generally would be capital, except to the extent section 751 (relating to unrealized receivables and inventory items) applies.

Third, the proposal would also expand the definition of “security” for section 165(g) purposes to include a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a partnership, with interest coupons or in registered form.

Separately, the proposal would introduce a new section 267 deferral mechanism to defer the recognition of losses with respect to the stock or securities of a liquidating corporation in a complete liquidation to which section 331 applies if the liquidating corporation and the distributee corporation are members of the same controlled group until such time as the distributee corporation disposes of substantially all of the properties it received in the liquidation to one or more unrelated persons. For this purpose, a controlled group is defined by reference to the section 1563(a) definition, with modified constructive stock ownership rules, and using a more than 50% of vote or value stock ownership threshold.

The proposal would grant Treasury regulatory authority to issue guidance as necessary to carry out the purposes of the modified section 267 provisions, including “to apply the principles of this subsection to liquidating corporation stock or securities owned by a corporation indirectly through one or more partnerships.”

The provisions concerning the worthless securities loss deduction would be applicable for losses arising in tax years beginning after December 31, 2021. The provisions concerning deferral of losses on the securities of a liquidating corporation within a controlled group would apply to liquidations occurring on or after the date of enactment.

The proposal is estimated to increase revenues by approximately $1.78 billion over 10 years.
commitment to sell its operating assets, to collectively comprise an identifiable event that dispelled reasonable expectation of future value in the subsidiary’s stock. In other cases, some courts have held that a single identifiable event (e.g., adoption of a plan of abandonment, execution of an agreement to sell all the subsidiary’s assets, etc.) by itself, may be insufficient to establish worthlessness in certain situations (e.g., when the subsidiary is not significantly insolvent); other objective and subjective evidences of additional identifiable events were required to substantiate the lack of current and future value. When a series of events take place that collectively (but not individually) establish worthlessness, the question becomes at which point the identifiable event that would determine the timing of the loss under the proposed rule is treated as having occurred. In other words, the proposal might present the “straw that broke the camel’s back” issue. Furthermore, another uncertainty exists in limited situations when an identifiable event is not a requirement to establish worthlessness—for example, when the corporation is hopelessly insolvent (i.e., the liabilities of the corporation are so greatly in excess of its assets and the nature of its business is such that there is no reasonable hope and expectation that its business will revive, and therefore its stock value had become extinct). In that case, presumably the “identifiable event” for purposes of applying the proposed timing rule could be the time when the hopeless insolvency occurs.

In many cases, it might not matter whether a security has become worthless at some point during a particular tax year or at the end of the year. However, there can be interactions with the time of an ownership change under section 382, and the timing could matter if additional time during the year of worthlessness would affect the holding period sufficiently to make the difference between a loss being a short-term capital loss versus a long-term capital loss.

With respect to the proposed modifications to section 165 for losses arising from worthless partnership interests, the technical explanation states that, under case law and IRS published guidance, generally, a partner will take an ordinary loss upon the worthlessness of its partnership interest if the partner claiming worthlessness has no share of any partnership liability immediately prior to the claim and a partner will take a capital loss upon the worthlessness of its partnership interest if the partner has a share of any partnership liability immediately prior to the claim. The explanation goes on to state that the sale or exchange treatment results from a shift in liabilities under section 752 in connection with a worthlessness claim. In fact, it is not clear that a taxpayer declaring its partnership interest worthless gives rise to a liability shift under section 752, as the taxpayer in this situation technically remains a partner. Courts addressing cases involving worthless partnership interests have allowed ordinary losses in situations in which the taxpayer had a share of partnership liabilities. For example, in In re Kreidle, 91-2 U.S.T.C. ¶50,371 (Bankr. D. Col. 1991), aff’d, 143 B.R. 941 (D.C. Col. 1992) (which is cited in the technical explanation), the bankruptcy court held that there was no deemed distribution under section 752 at the time the partnership interest became worthless because there was no discharge of liabilities that would have given rise to a decrease in liabilities.

The proposal would treat a loss arising from worthless partnership interest the same way as a sale or exchange of partnership under section 741 regardless of whether the partner has a share of partnership liabilities under section 752. This treatment generally would cause the character of the loss to be capital, subject to the rules of section 751 (relating to unrealized receivables and inventory items).

Notably, the proposed amendment does not, by its terms, address the treatment of the abandonment of a partnership interest.

The proposed deferral of stock losses on complete liquidations appears to be aimed squarely at Granite Trust planning. At a high level, a Granite Trust transaction generally involves a transaction in
which a parent corporation attempts to recognize a loss on the stock of a subsidiary, and to avoid
the application of the tax-free subsidiary liquidation rules of section 332 by reducing its stock
ownership in a controlled subsidiary below the relevant 80% stock ownership requirement, thereby
positioning it to recognize a stock loss under section 331 upon the subsidiary’s complete
liquidation. The parent corporation, under current law, may effectively reduce its stock ownership in
the subsidiary below 80% by selling a sufficient amount of its stock in the subsidiary to any person
outside of the consolidated group of which the parent corporation is a member. Such a transaction
often takes the form of a sale of, say, 30% of the subsidiary’s stock to a related partnership or
foreign corporation. Under current law, although section 267(f) can apply to defer or disallow losses
between corporations within the same controlled group (and thus can defer the parent’s loss on
the 30% interest in the stock of the liquidating corporation), it does not apply to the parent’s loss
on its remaining 70% stock interest in the liquidating corporation. The proposed deferral rule,
however, would provide that no loss may be recognized by the parent (distributee) corporation with
respect to the stock or securities of the liquidating corporation exchanged for the property of the
liquidating corporation in the liquidation until the distributee corporation disposes of substantially all
of such property to a party that is not related to the distributee corporation. The deferral
mechanism focuses on the actual “exit” of the assets of the liquidated subsidiary, and appears to
mimic similar provisions in section 267(f)(2), which provides that any loss from the sale or
exchange of property between members of the same controlled group is deferred until the
property is transferred outside such controlled group and there would be recognition of loss under
consolidated return principles (or until such other time as may be prescribed in regulations). If
enacted, the proposed deferral rule can be anticipated to reduce the volume of the common
Granite Trust type tax planning that has been around for quite some time (i.e., since the Granite
Trust case was decided in 1943). While the proposed deferral rule would simply defer, but not
disallow, the stock loss, the requirement that the underlying assets must be sold to unrelated
parties to trigger recognition of the stock loss may significantly diminish interest in this kind of tax
planning.

It is curious that the proposal attempts to limit a taxpayer’s ability to control the timing of triggering
a built-in stock loss in a solvent subsidiary, while continuing to provide a taxpayer some ability to
control the timing of a worthless securities loss in certain circumstances through timing an
identifiable event (e.g., a check-the-box election as in Rev. Rul. 2003-125). One possible
explanation is that, in the case a worthless securities loss, the loss is fixed by an identifiable event
and is complete, while in the context of Granite Trust planning the loss might be viewed as less
complete.

While the proposal would defer stock losses within the controlled group, it would not affect the
timing of a stock loss recognized by an otherwise unrelated minority shareholder in the liquidating
corporation. In addition, the proposal would not affect the rules in section 336 that generally require
the liquidating corporation to recognize its asset-level gains and losses on the complete liquidation.

Adjusted basis limitation for divisive reorganizations

A divisive reorganization under sections 368(a)(1)(D) and 355, commonly referred to as a spin-off
transaction (a “Divisive Reorganization”), involves the transfer by a distributing corporation (“D”) of
property to a controlled corporation (“C”) in exchange for C stock, followed by D’s distribution of the C
stock to its (D’s) shareholders. Often, C also issues its debt securities or transfers money (e.g., the
proceeds of borrowing or an initial public stock offering) to D as partial consideration in the exchange,
which generally can be received and distributed tax-free by D to its shareholders and creditors under
current law.
Section 361(a) generally provides that D does not recognize gain or loss on its transfer of property to C solely in exchange for C stock and C securities. Section 361(b)(3) generally extends D’s nonrecognition treatment to its receipt of money or other property from C (i.e., “boot”), provided that D distributes such boot to its shareholders or creditors in pursuance of the plan of reorganization. In addition, section 361(c)(3) generally provides that D does not recognize gain on its distribution of C stock, C securities, or other C debt obligations to its (D’s) shareholders or creditors in pursuance of the plan of reorganization.

Currently, there are a number of provisions that are intended to limit D’s ability to monetize and extract value from C in a tax-free manner in connection with a Divisive Reorganization. First, section 357(c) limits the amount of D liabilities that may be assumed tax-free by C in connection with a Divisive Reorganization. Second, the 1997 enactment of the so-called anti-Morris Trust rules in section 355(e) requires D to recognize gain on its distribution of C stock and securities if one or more persons acquires stock in either D or C representing a 50% or greater interest, as part of a plan which includes the distribution. Third, the 2004 addition of language to section 361(b)(3) limits D’s tax-free receipt of boot from C that is then transferred to creditors to the sum of the money and adjusted tax bases in property that D transferred to C (reduced by the amount of liabilities assumed by C) (the “Adjusted Basis Limitation”). Fourth, the 2006 addition of the disqualified investment company rules of section 355(g) generally precludes tax-free distributions if the fair market value of the investment assets of either D or C comprises 75% or more of the aggregate value, respectively, of all of D’s or C’s assets.

The proposal is described in the JCT technical explanation as tightening the Adjusted Basis Limitation by requiring D to recognize gain by the amount, if any, that C securities distributed by D to its creditors exceeds D’s net bases in the properties it transfers to C reduced by the money and other property transferred by C to D in the reorganization.

However, the proposed statutory language contains a different formulation, in that it effectively tightens the Adjusted Basis Limitation by requiring D to recognize gain by the amount, if any, that money or other property received by D from C and distributed to D’s creditors exceeds D’s net bases in the properties it transfers to C reduced by the C securities distributed to the D creditors.

The modifications to the Adjusted Basis Limitation would apply to Divisive Reorganizations occurring on or after the date of enactment of the proposed legislation and, as proposed, without any grandfather rule for pending transactions.

The proposal is projected to generate revenue of approximately $20.7 billion over the 10-year budget window.
The current Adjusted Basis Limitation allows D to establish new debt capital structures for D and C by permitting D to transfer to its creditors, without recognizing gain, the boot received from C, up to an amount equal to D’s adjusted basis in the assets transferred to C (reduced by liabilities assumed). In addition, the current Adjusted Basis Limitation does not restrict the amount of C securities that D may transfer to its creditors on a tax-free basis.

As explained in the [staff summary and the technical explanation], the proposal is intended to limit the extent to which D may transfer C debt securities to its creditors tax-free in connection with a Divisive Reorganization by limiting, not only the amount of money that D may transfer to creditors and the amount of D liabilities that C may assume, but also the amount of C securities that D may transfer to creditors, to D’s adjusted basis in assets transferred to C. By imposing such limitation, the proposal would further restrict D’s ability to reallocate its debt to C on a tax-free basis in connection with a Divisive Reorganization.

The proposed limitation may be illustrated by the following example:

In a transaction that otherwise qualifies as a Divisive Reorganization, D transfers assets with a tax basis of $100X and a fair market value of $200X, to C in exchange for: (1) assumption by C of $50X of D liabilities; (2) C common stock with a fair market value of $90X; (3) C debt securities in the principal amount of $40X; and (4) cash in the amount of $20X. Pursuant to the plan of reorganization, D distributes C common stock with a fair market value of $80X to its shareholders in exchange for outstanding D stock. In connection therewith, D transfers to its creditors in repayment of pre-existing D debt: (1) C common stock with a fair market value of $10X; (2) C debt securities in the principal amount of $40X; and (3) cash in the amount of $20X.

Under current law, because the excess of the sum of the money and the fair market value of other property transferred to D creditors in connection with the reorganization (i.e., $20X of cash) does not exceed the adjusted bases of the assets transferred to C, reduced by the amount of D liabilities assumed by C (i.e., $100X of tax basis in assets transferred to C – $50X of D liabilities assumed by C = $50X current Adjusted Basis Limitation), D recognizes no gain on the transfer of such consideration to the creditors. The C debt securities transferred to the D creditors ($40X) are treated as qualified property distributed to D shareholders with respect to which no gain or loss is recognized.

Under the proposal, because (A) the sum of (i) liabilities assumed by C in connection with the reorganization (i.e., $50X of D liabilities assumed), (ii) the amount of money and fair market value other property transferred by D to creditors (i.e., $20X of cash), and (iii) the principal amount of C debt securities that is qualified property transferred by D to its creditors (i.e., $40X C debt securities), exceeds (B) the total adjusted bases of assets transferred by D to C (i.e., $100X tax basis in assets transferred), D is required to recognized gain up to the amount of money and fair market value of other property that is transferred to creditors (i.e., up to $20X of cash) equal to such excess (i.e., $50X of D liabilities assumed + $20X of cash transferred to creditors + $40 X of C debt securities transferred to creditors – $100X of tax basis in assets transferred = $10X of gain recognized by D).

As the proposed amendment is currently drafted, the amount of C securities that D can receive and distribute tax-free remains unchanged, and to this extent the statutory language used in the proposed amendment does not appear to fully line up with the description of the proposal in the [staff summary and the technical explanation]. For example in the above example, if instead of issuing $20X of cash, C were to issue $60X of C debt securities, which D then distributes to shareholders or creditors, there would be no gain recognized by D under the proposed...
amendment. In addition, under the proposed amendment, the limitation would only be applicable if money or other property is received by D and such money or other property is distributed to creditors; therefore the proposed amendment does not appear to apply if the money or other property (i) is not received by D or (ii) is received by D and is distributed only to shareholders.

Regardless of the specific language used in the proposal, taxpayers that are currently planning a Divisive Reorganization (or that will do so in the future) would be advised not to rely on the apparent ability under the proposed language to avoid tax when C securities rather than cash are transferred to the D creditors. Given that such an ability appears inconsistent with the language in the accompanying report, it is quite possible that the legislative language will be altered to expand its scope. Thus, taxpayers can be expected to employ alternative structures to the extent available and practical, that will allow for an appropriate allocation of debt between D and C without the incurrence of additional tax.

Rents from prison facilities not treated as qualified income for purposes of REIT income tests

This proposal would revise section 856(d)(2) so as to treat as nonqualifying income any amount (including rental income) received or accrued, directly or indirectly, with respect to any property which is primarily used in connection with any correctional, detention, or penal facility.

The JCT has estimated that the proposal would raise $130 million over 10 years.

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

KPMG observation

The proposal follows measures taken by the Biden Administration to limit the federal government’s commercial relationships with so-called “private prison” operators. Two U.S. listed companies have operated as REITs while focusing on the operation of prisons. One, CoreCivic, announced that it would revoke its REIT election and operate as a regular C corporation beginning in 2021. The other, GEO Group, has previously announced that it is currently evaluating its status as a REIT.

Modifications to exemption for portfolio interest

Current law

A foreign person generally is subject to a 30% gross-basis income withholding tax on fixed or determinable annual or periodical income, such as interest and dividends, received from sources within the United States that is not effectively connected with the conduct of a trade or business within the United States.

There is an exception (referred to as the “portfolio interest exemption”) from such withholding for U.S. source interest (including original issue discount (“OID”)) received by certain foreign persons. More specifically, under the portfolio interest exemption, payments of non-contingent U.S. source interest are exempt from U.S. federal withholding tax unless (i) the interest is received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business, (ii) the recipient is a “10-percent shareholder” of the obligor within the meaning of section 871(h)(3)(B), or (iii) the recipient is a controlled foreign corporation (a “CFC”) and receives the interest from a “related
person” within the meaning of section 864(d)(4). In addition, the obligation must be in “registered form,” and a properly completed and executed IRS Form W-8 BEN-E or other appropriate certification must be furnished certifying that the recipient is a foreign person, as defined in the applicable Treasury Regulations.

Portfolio interest, however, does not include interest received by a 10% shareholder. For this purpose, a 10% shareholder is, in the case of an obligation issued by a corporation, any person who owns 10% or more of the total combined voting power of all classes of stock of such corporation entitled to vote, or, in the case of an obligation issued by a partnership, any person who owns 10% or more of the capital or profits interest in such partnership.

The proposal

The proposal provides that, in the case of an obligation issued by a corporation, a 10% shareholder is (1) any person who owns 10% or more of the total combined voting power of all classes of stock of such corporation entitled to vote or (2) any person who owns 10% or more of the total value of the stock of such corporation.

The proposal would apply to obligations issued after the date of enactment.

The JCT has estimated that the proposal would raise $2.1 billion over a 10-year period.

KPMG observation

The proposal would expand the definition of a 10% shareholder of an issuing corporation to include any person who owns 10% or more of the total value of the stock of the issuing corporation. Thus, under the proposal, certain non-voting shareholders in an issuing corporation could be 10% shareholders and would not be eligible for the portfolio interest exemption. The proposal therefore could eliminate certain structures whereby two classes of stock, voting and non-voting, are issued as a means of preventing a shareholder from being classified as a 10% shareholder. The proposal would not alter the definition of a 10% shareholder of a partnership.

Modification to treatment of certain partnership interest derivatives

Current law

Under current section 871(m), amounts treated as “dividend equivalents” are treated as US-source dividends, subject to 30% U.S. withholding tax (unless reduced by a tax treaty). A dividend equivalent for these purposes is generally a payment that is contingent upon, or determined by reference to, the payment of a US-source dividend arising from (i) a substitute dividend payment made pursuant to a securities lending or sale-repurchase transaction, (ii) payments made pursuant to a “specified notional principal contract,” (iii) payments made pursuant to a “specified equity-linked instrument,” or (iv) other substantially similar payments. See section 871(m)(2) and Treas. Reg. section 1.871-15. Regulations under section 871(m) provide special rules and definitions to apply with respect to specified notional principal contracts and specified equity-linked instruments for these purposes.

Under section 7704, partnerships the interests of which are traded on an established securities market or are readily tradeable on a secondary market (“publicly traded partnerships” or “PTPs”) are generally treated as corporations for U.S. federal income tax purposes. However, section 7704(c) precludes PTPs that meet certain passive-type income requirements from being treated as corporations for U.S. federal
income tax purposes, and as a result, section 871(m) is not currently applicable to payments determined by reference to income or gain arising from such PTPs.

Income arising from a notional principal contract is generally sourced to the residence of the recipient of the payment. Treas. Reg. section 1.863-7(b)(1). However, if the notional principal contract income arises from a US trade or business, the income is treated as “effectively connected” with the conduct of a US trade or business, which is taxable at rates generally applicable to US taxpayers. Treas. Reg. section 1.863-7(b)(3).

The proposal

Under the proposal, any payment made pursuant to a sale-repurchase transaction, a specified notional principal contract, or any other similar payment as the Treasury Secretary provides that is determined by reference to any income or gain in respect of an interest in a “specified partnership,” would be treated as a dividend equivalent, subject to 30% U.S. withholding tax (unless reduced by a tax treaty). A specified partnership for these purposes is any PTP (as defined in section 7704(b)) that is not treated as a corporation under section 7704 (i.e., PTPs that meet certain passive income requirements described in section 7704(c)), or any other partnership as the Secretary may prescribe under regulations.

The proposal provides exceptions for “excepted contracts” and “certain Income.” “Excepted contracts” are contracts or transactions that the Secretary determines do not have the potential for tax avoidance. “Certain income” is, under regulations to be prescribed by the Secretary, payments the income or gain from which would be either exempt from US income tax or treated as non-US source income if paid to a nonresident alien individual. Accordingly, through future regulations, the proposal would generally only apply to relevant payments determined by reference to US source, non-exempt income or gain in respect of an interest in a specified partnership.

Rules similar to the rules and definitions of section 871(m)(3), (4), (5), (6), and (7) would apply to an interest in a specified partnership in a manner similar to an underlying security, and to income or gain in respect of an interest in a specified partnership in a manner similar to a dividend. The proposal indicates that the Secretary may prescribe regulations, under rules similar to section 1446(f), to determine the manner in which the amount of income and gain is determined for amounts treated as dividend equivalents under the proposal.

The proposal would apply to payments made on or after the date that is 180 days after the enactment date of the Act.

The JCT has estimated that the proposal would raise approximately $90 million over 10 years.

KPMG observation

The proposal’s application of section 871(m) to sale-repurchase transactions (“repos”) of specified partnership interests could cause confusion around the proper taxation of such transactions. Under general tax principles, repos are typically treated as secured loans and are not viewed as transferring tax ownership of the underlying property. Any payments by the repo lender would generally be treated as payments on the underlying securities, in this case, the specified partnership interest. Under common law, such payments would be subject to general sourcing and withholding rules for partnership income, including section 864(c)(8). The proposal characterizes such payments as dividends from domestic corporations.
Interestingly, the proposal omits payments made pursuant to securities lending transactions from the proposed rule, a payment type that is included in the statute of current section 871(m)(2) as it otherwise applies. It is unclear whether there is regulatory authority to expand the rule to apply to securities lending transactions. The rule that currently applies regarding payments made pursuant to a specified equity-linked instrument is a regulatory rule, so it is not surprising that a similar rule was not included in the proposal for interests in specified partnerships.

The exceptions in the proposal with respect to “excepted contracts” and “certain income” seem linked to regulations or guidance to be prescribed by the Secretary. Given the uncertainty around whether such provisions are self-enabling and the importance of certainty for withholding agents that must implement these rules, additional clarification of Congressional intent would be helpful.

The proposal would apply rules similar to the other paragraphs of section 871(m) to the proposal, including section 871(m)(3). The final regulations under Treas. Reg. section 1.871-15 extended the narrow definition of a specified notional principal contract provided in section 871(m)(3)(A) generally to transactions entered into before January 1, 2017, and then implemented a new definition in lieu of the broad default definition in the statute. The IRS and Treasury have subsequently modified the effective date of certain provisions through Notices. Presumably, the proposal’s definition of a specified notional principal contract would be based on these regulatory definitions as modified by the Notices (i.e., delta one notional principal contracts).

According to current regulations under section 871(m), determinations about whether a notional principal contract is subject to section 871(m) are generally made at the earlier of when the transaction is priced and when the transaction is issued. See Treas. Reg. section 1.871-15(g)(2)(ii). Notably, the proposal would apply to payments made on or after the date that is 180 days after its enactment, rather than transactions entered into after the date that is 180 days after the date of enactment. For payments made after the effective date on potential specified notional principal contracts that were previously issued, it is unclear if taxpayers would be required to “go back in time” to the issue date or pricing date to determine whether the transaction is subject to section 871(m).

The proposal states that the Secretary may prescribe regulations to determine the manner in which the amount of income and gain is determined for purposes of the proposed rule. The technical explanation seems to elaborate, stating that PTPs themselves must provide relevant information to withholding agents in order to determine the portion of notional principal contract income attributable to the income or gain of a PTP within the scope of the proposed rule. The mechanism by which withholding agents would obtain all relevant information about a PTP in this scenario is unclear. For example, the proposal does not address the interaction between payments on a section 871(m) transaction and the relevant income or gain on PTPs. Perhaps this would necessitate some sort of reconciliation between the taxable income of a PTP, distributions of a PTP, and payments on a section 871(m) transaction to determine the relevant information. It seems that these operating rules are left to the Secretary to provide.

Treas. Reg. section 1.871-15(m) currently provides rules relating to derivatives that reference partnerships. Under these regulations, a potential section 871(m) transaction that references a partnership interest is treated as referencing the assets that the partnership holds if certain requirements are met. These so-called “look-through rules” in the regulations would presumably need to be modified to account for the proposal, if enacted.
Modification of rules for partnership interests held in connection with the performance of services

Under current law, section 1061 recharacterizes long-term capital gain allocated with respect to an applicable partnership interest (API) or recognized upon the disposition of an applicable partnership interest as short-term capital gain unless the asset sold has a greater than three-year holding period. As drafted, section 1061 applies only to gain recognized with respect to the disposition of a capital asset. Section 1061 does not apply to section 1231 gain and other capital gain items that are not generated from the disposition of a capital asset (e.g., qualified dividend income, section 1256 gain, etc.).

The proposal would amend section 1061 in a number of significant ways.

As a threshold matter, the proposed amendment would no longer operate by reference to the holding period of the asset sold. Instead, the relevant holding period would start by reference to when “substantially all” of the interests held by the API holder and assets held by the underlying partnership had been acquired.

More specifically, amended section 1061 would create a concept of “net applicable partnership gain” that would be recharacterized as short-term capital gain for the relevant tax year. Under the general rule, net applicable partnership gain would include all long-term capital gain items recognized with respect to an API. Under this rule, the scope of long-term capital gain items subject to recharacterization no longer would be limited to gain from the disposition of a capital asset. Instead, section 1231 gain, qualified dividend income, section 1256 gain, and potentially other long-term capital gain items could be recharacterized as short-term capital gain.

The proposed new approach to addressing the relevance of asset holding period comes in the form of an exception to the general rule. Under the exception, the satisfaction of the relevant holding period would prevent recharacterization of long-term capital gain. According to the exception, “net applicable partnership gain would be determined without regard to any amount which is realized after the date that is five years after the latest of (i) [t]he date on which the taxpayer acquired substantially all of the applicable partnership with respect to which the amount is realized, [or] (ii) [t]he date on which the partnership in which the partnership is held acquired substantially all of the assets held by such partnership.” (These rules apply on a look-through basis with respect to lower-tier partnership interests.) In effect, five years after the API holder acquired substantially all of its API in the partnership and after the relevant partnership acquired substantially all of its assets, any long-term capital gain recognized with respect to the API would not be subject to recharacterization. The proposed amendment provides no guidance as to the meaning of “substantially all.”

KPMG observation

Note that some of the long-term capital gain items recharacterized are not holding-period dependent (e.g., qualified dividend income and section 1256 gain), and it may have been necessary to adopt an approach that ignores the holding period of specific assets in order to capture these items. Clearly, however, the approach adopted by the amendment has the effect of extending the holding period well beyond five years for most assets.

The five-year period would be reduced to three years in certain instances. The shorter holding period would apply to taxpayers (other than trusts or estates) with adjusted gross income (determined without regard to section 911, 931, and 933) of less than $400,000. The three-year period also would apply to income with respect to any API that is attributable to a real property trade or business within the
meaning of section 469(c)(7)(C). It appears that the real property trade or business would be determined at the partnership level without regard to the participation of the API holder.

Beyond alteration of the rules providing for the recharacterization of long-term capital gain, the amendment would make another very significant change – that is, section 1061(d) would be amended to provide that any transfer of an API would result in gain recognition without regard to any nonrecognition provisions that might otherwise apply to the transaction.

KPMG observation
The impact of this proposed amendment cannot be overstated. The rule would impact gifts of APIs, transfers upon death, restructuring transactions to divide carry and management operations in anticipation of a “GP Stakes” transaction (i.e., a partial sale of the sponsor business), and partnership merger transactions when partners in the target partnership hold APIs, among others.

The proposed amendment also would make minor changes to the definition of an API, most significantly providing regulatory authority to address certain situations. First, regulatory authority would be provided to modify the rule treating a partnership interest as a specified asset by reference to specified assets held by the partnership. According to the JCT technical explanation, this regulatory guidance may “define a de minimis direct or indirect interest of a partnership in an asset that is not taken into account for this purpose.” Second, regulatory guidance may override the exceptions to API treatment for capital interests as well as partnership interests held by C corporations. The JCT technical explanation indicates that this regulatory authority could be invoked “when the application of an exception would not carry out the purposes of section 1061.”

The amendment continues to provide regulatory authority to exclude from recharacterization “income or gain attributable to any asset not held for portfolio investment on behalf of third-party investors.”

KPMG observation
Treasury and the IRS did not invoke this regulatory authority in the regulations that were finalized earlier this year. As a result, issues relating to enterprise value and family partnerships remain unaddressed. These issues would take on added importance as a result of the new holding-period rules.

Finally, the amendment would add specific grants of regulatory authority “to prevent the avoidance of the purposes of [section 1061], including through the distribution of property by a partnership and through carry waivers” as well as to provide for the application of section 1061 “to financial instruments, contracts or interests in entities other than partnerships to the extent necessary or appropriate to carry out the purposes of [section 1061].”

KPMG observation
Interestingly, existing regulations under section 1061 address distributions of property and treatment of financial instruments, contracts, and interests in non-corporate entities, so the regulatory authority provided in amended section 1061 would seem only to confirm the validity of those regulations. Carry waivers would seem to be much harder (if not impossible) to accomplish.
under the new holding-period regime, so it is not clear how prevalent carry waivers would be after the amendment and whether regulations addressing such waivers would have significant impact.

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

The JCT has estimated that this proposal would raise approximately $14.12 billion over 10 years.

KPMG observation

This effective date obviously is relevant as parties determine when to dispose of investment fund assets. Given the provision overriding nonrecognition, the effective date is also highly relevant to completing gifting transactions, internal restructurings, and other nonrecognition transactions that could involve the disposition of an API.

Limitation on certain special rules for section 1202 gains

Under current section 1202, a person other than a corporation may exclude from income a certain percentage of the gain from the sale or exchange of qualified small business stock (“QSBS”) that the taxpayer held for more than five years. The percentage of gain that may be excluded depends on the date that the taxpayer acquired its stock:

- Stock acquired after September 27, 2010 is eligible for a 100% exclusion (“100% exclusion rule”),
- Stock acquired after February 17, 2009 and before September 28, 2010 is eligible for a 75% exclusion (“75% exclusion rule”), and
- Stock acquired after August 10, 1993 and before February 18, 2009 is eligible for a 50% exclusion (“50% exclusion rule”).

The remaining 25% and 50% of gain for taxpayers subject to the 75% and 50% exclusion rules, respectively, are subject to tax at a maximum 28% rate rather than the current long-term capital gains rate of 20% (not taking into account the 3.8% net investment income tax). Moreover, 7% of the amount excluded from gross income under these two regimes is treated as a tax preference item for purposes of the alternative minimum tax.

Taxpayers also are subject to a per-issuer limitation on eligible gain subject to the exclusion generally equal to the greater of (i) $10 million ($5 million for married taxpayers filing separate returns), reduced by gain taken into account by the taxpayer with respect to the same issuer in prior years, and (ii) ten times the taxpayer’s basis in the qualifying stock of the issuer disposed of in the tax year.

Under section 1045, an individual may elect to roll over tax-free any gain realized on the sale of qualified small business stock held more than six months to the extent of the taxpayer’s cost of purchasing other qualified small business stock within 60 days of the sale.

Under the proposal, the 100% and 75% exclusion rules would not apply for (i) taxpayers with adjusted gross income (determined without regard to section 1202 as well as sections 911, 931, and 933) that equals or exceeds $400,000 and (ii) for taxpayers that are a trust or estate. As such, these taxpayers would be able to exclude only 50% of the gain from the sale or exchange of QSBS, regardless of when the stock was acquired after August 10, 1993.

This proposal would apply to sales or exchanges on or after September 13, 2021, except that the
The proposal would not apply to any sale or exchange made pursuant to a written binding contract which was in effect on September 12, 2021 and is not modified in any material respect thereafter.

The JCT has estimated that this proposal would increase revenue by approximately $5.7 billion over the 10-year budget window.

**KPMG observation**

Congress enacted section 1202 as “targeted relief for investors who risk their funds in new ventures, small businesses, and specialized small business investment companies”, . . . [to] “encourage investments in these enterprises” . . . [and to] “encourage the flow of capital to small businesses, many of which have difficulty attracting equity financing.” See, e.g., H. Rep. 103-111, 103d Cong. 1st Sess. (May 25, 1993).

The effective date of this proposal would likely disrupt the expectations of many investors who made their investment decisions based on then-applicable law. Thus, the effective date of this proposal could in a sense penalize the very taxpayers that successfully undertook what the legislation urged them to do – put their equity capital at risk in a new venture to create a successful business. The prior changes to the exclusion percentage were based on the date of a taxpayer’s investment in the issuing corporation. The effective date of this proposal would eliminate an expected benefit available when the original investment decision was made.

**KPMG observation**

The proposal also would reinstate the significant complexity that existed prior to the adoption of the 100% exclusion rule, including a two-tier rate on recognized gain and the reimposition of an alternative minimum tax preference for 7% of the excluded gain.

The reimposition of the 50% exclusion also would resuscitate mechanical ambiguities that do not exist under the 100% exclusion rule. For example, in the proposal it is unclear whether the 50% exclusion would apply before or after the application of the greater of $10 million or ten-times basis limitation.

**KPMG observation**

As highlighted by the technical explanation, the $400,000 threshold would be calculated without regard to section 1202, and therefore a taxpayer with $400,000 of eligible gain on the sale of QSBs would be subject to the 50% gain exclusion, while a taxpayer with $399,999 of eligible gain (and no other gross income) would be eligible for the full 100% exclusion. While the per-issuer limitation applicable to each taxpayer currently provides incentives for taxpayers to undertake certain permitted transfers of QSBs to other persons, the reimposition of the 50% exclusion percentage based on a taxpayer’s income could further encourage taxpayers to undertake such transfers or to split up the amount of QSBs sold in a year. Such actions could either reduce the transferring taxpayer’s income below the $400,000 threshold and/or permit a transferee person below that threshold to apply the 100% exclusion.
KPMG observation

To the extent a taxpayer must sell all of their QSBS in a year and would thus exceed the $400,000 threshold, a taxpayer could potentially avail themselves of the section 1045 rollover for the gain in excess of the threshold in order to allow them the flexibility to choose the amount of gain to recognize in each subsequent year to remain below the $400,000 threshold.

Constructive sales

Current law

In general, in the case of a constructive sale of an appreciated financial position, a taxpayer must recognize gain as if the position were sold, assigned, or otherwise terminated at its fair market value on the date of the constructive sale. Any gain or loss realized after the constructive sale with respect to the position is adjusted to reflect any gain taken into account as a result of the constructive sale. In addition, the holding period of the position is determined as if the position were originally acquired on the date of the constructive sale.

An appreciated financial position is, generally, any position with respect to any stock, debt instrument, or partnership interest if there would be gain were such position sold, assigned, or otherwise terminated at its fair market value. A position is defined as an interest, including a futures or forward contract, short sale, or option.

A taxpayer is treated as having made a constructive sale of an appreciated financial position if the taxpayer (or a related person) (A) enters into a short sale of the same or substantially identical property, (B) enters into an offsetting notional principal contract with respect to the same or substantially identical property, (C) enters into a futures or forward contract to deliver the same or substantially identical property, (D) in the case of an appreciated financial position that is a short sale or a contract described in (B) or (C) with respect to any property, acquires the same or substantially identical property, or (E) to the extent prescribed by the Secretary in regulations, enters into one or more other transactions (or acquires one or more positions) that have substantially the same effect as a transaction described in the preceding sentence.

The proposal

The proposal would add “digital asset” to the definition of appreciated financial position. A digital asset for these purposes means any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary. Thus, a constructive sale of a digital asset would be subject to the general rule for constructive sales, such that a taxpayer must recognize gain as if the position with respect to the digital asset were sold, assigned, or otherwise terminated at its fair market value on the date of the constructive sale.

The definition of constructive sale outlined in (D) above would be expanded to include situations when a taxpayer has an appreciated short sale, notional principal contract, forward contract, or futures contract and enters into a contract to acquire the same or substantially identical property.
KPMG observation

This proposed expansion of the constructive sale rules will be of particular interest to taxpayers that seek to monetize their appreciated cryptocurrency positions without disposing of them.

Currently, an appreciated short sale, short swap, or short forward or futures contract is constructively sold when the taxpayer acquires the reference property. This proposal would expand this rule to trigger a constructive sale if the taxpayer “enters into a contract to acquire” the reference property such that a constructive sale could occur if a taxpayer enters into an offsetting long derivative rather than acquiring an outright position in the underlying reference property.

The proposal would apply to constructive sales and contracts entered into after the date of enactment.

The JCT combined the revenue impact of this proposal with the estimate for the following proposal.

Rules relating to common control

Section 52 currently provides aggregation rules for both corporate entities and non-corporate entities. In general, section 52(a) provides for aggregation of a controlled group of corporations meeting a more than 50% common ownership standard. Section 52(b) provides a similar rule for non-corporate organizations (partnerships, trusts, estates, and sole proprietorships) of trades or businesses.

The proposal would amend section 52(b) to provide that a trade or business includes any activity treated as a trade or business under section 469(c)(5) or (6). Section 469(c)(5) deals with a trade or business activity involving research and experimentation. Section 469(c)(6) trade or business includes any activity in connection with a trade or business or any activity with expenses deductible under section 212.

The proposal would apply to tax years beginning after December 31, 2021.

The JCT has estimated this proposal would increase revenue by approximately $19.6 billion over the 10-year budget window.

KPMG observation

Section 52 has been frequently incorporated in recent legislation. However, the application of section 52 with respect to non-corporate trades or businesses has not previously been an area of Congressional focus. The proposed amendment would give more refined meaning to the term “trade or business” in this context in a manner that would generally be unfavorable to affected taxpayers.

Wash sales by related parties; wash sales of specified assets

In general, the current law wash sale rules disallow a loss on the sale of a stock or security if the taxpayer acquires substantially identical stock or securities, or enters into a contract or option to acquire substantially identical stock or securities, within the 61-day period starting 30 days before the sale date. For this purpose, the term “stock or securities” generally includes contracts or options to acquire or sell stock or securities.
The basis of the acquired stock or securities (or the contract or option entered into) that resulted in denial of the loss from the sale or other disposition of substantially identical stock or securities is increased by the amount of disallowed loss. The holding period of the replacement stock or securities is also adjusted to include the holding period of the stock or securities that were sold.

The proposal would modify the wash sale rules to apply to a loss claimed with respect to any sale or other disposition of a “specified asset,” which would include:

- Any share of stock in a corporation;
- Any partnership or beneficial ownership interest in a widely-held or publicly-traded partnership or trust;
- Any note, bond, debenture, or other evidence of indebtedness;
- Any foreign currency;
- Any commodity which is actively traded;
- Any interest rate, currency, equity, or actively-traded commodity notional principal contract;
- Any evidence of an interest in, or a derivative financial instrument in, any of the foregoing, including any option, forward contract, futures contract, short position, and any similar financial instrument in such a security, actively-traded commodity, or currency; and
- Any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary.

Except as provided in regulations, the term “specified asset” would also include contracts or options to acquire or sell any specified assets.

**KPMG observation**

The term “stock or securities” is not defined in section 1091 or the regulations thereunder. However, it has generally been interpreted to exclude foreign currency, commodities, commodities derivatives, and cryptocurrencies. By replacing “stock or securities” with “specified asset” Congress would greatly expand the scope of the wash sale rules.

The proposal would also modify the wash sale rules to disallow losses in cases when a related party has acquired a replacement position. For this purpose, a related party would be broadly defined to include the taxpayer’s spouse, dependents of the taxpayer, persons to whom the taxpayer is a dependent, and a wide variety of entities (e.g., a corporation controlled by the taxpayer) and tax-advantaged plans (e.g., IRAs and section 529 plans) if certain requirements are satisfied. The provision would also authorize the Secretary to issue regulations or additional guidance to prevent the avoidance of the wash sale rules through the use related parties.

In the case of any acquisition of substantially identical specified assets by a related party other than the taxpayer’s spouse, the basis of the substantially identical specified assets would not be adjusted to include the disallowed loss. If the substantially identical specified assets are acquired by the taxpayer or the taxpayer’s spouse during the period beginning 30 days before the sale and ending on the close of the taxpayer’s first tax year after the sale, the basis of the acquired specified assets would be increased by the amount of the disallowed loss.
KPMG observation

Although the IRS previously applied the wash sale rules across related parties in published guidance, many questioned the technical merits of this position. The proposal would provide a statutory basis for applying the wash sale rules across the enumerated types of related parties and also grant regulatory authority to allow the Treasury Department and IRS to address related party situations that are not specifically covered by the proposal. The application of the wash sale rules across related parties would require adjustments to the taxpayers’ systems and processes for identifying wash sale transactions.

The related party rules are also notable in that they could transform what was a temporary loss deferral provision into a permanent loss disallowance rule by providing for a basis adjustment only if the taxpayer or the taxpayer’s spouse acquires the replacement specified asset. It appears that this approach was chosen to limit taxpayers’ ability to use the wash sale rules to shift losses amongst related parties. The potential for a permanent loss disallowance would represent a significant trap for the unwary and, if enacted, taxpayers would be well advised to coordinate closely with related parties to avoid inadvertent wash sale transactions.

The proposal would allow basis adjustments if the taxpayer or the taxpayer’s spouse acquires substantially identical specified asset during the period beginning 30 days before the date on which the loss position was sold and ending with the close of the following tax year. It is not entirely clear why the basis adjustment window is longer than the wash sale window, but it could be intended to reduce the likelihood of permanent loss disallowance.

The proposal would not modify the holding period adjustment rules to incorporate the “specified asset” language and does not indicate whether holding period adjustments would be made in cases when a basis adjustment is not allowed. It is possible these omissions may have been inadvertent.

The proposal contains an exception for foreign currency and commodities losses that are either:

- Directly related to the business needs of a trade or business of the taxpayer (other than the trade or business of trading foreign currencies or commodities); or
- Part of a hedging transaction (as defined by section 1221(b)(2)).

KPMG observation

The business needs exception would undoubtedly be welcome news to taxpayers that frequently use currencies or commodities in the ordinary course of their trade or business. However, the proposal does not elaborate on what types of transaction would be considered directly related to the business needs of a trade or business. The hedging transaction exception is also very important because it would ensure that hedging transactions (which would frequently be specified assets) would not be caught up in the wash sale loss disallowance rules.

The proposal would apply to sales and other dispositions occurring after December 31, 2021.

The JCT has estimated that this proposal would raise approximately $16.76 billion over 10 years.
Tax increases for high-income individuals

Increase in top marginal individual income tax rate

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. For tax year 2022, according to the technical explanation of the Ways and Means proposals, the JCT projects that the 37% rate will apply to taxable income over $646,150 for married individuals filing a joint return and surviving spouses, $538,475 for unmarried individuals (other than surviving spouses), $538,450 for head of household filers, and $323,075 for married individuals filing a separate return.

The TCJA also temporarily modified the tax brackets for trusts and reduced the top marginal tax rate of 39.6% to 37% for tax years 2018 through 2025.

The proposed modifications are consistent with the Green Book proposal released in May in that they 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. However, the Ways and Means proposal would provide taxable income thresholds at which the 39.6% tax bracket begins that are significantly lower than the Green Book proposal. In addition, these brackets would be indexed for inflation based on a different calendar year than the other tax brackets.

Under the proposal, beginning in tax year 2022, the 39.6% top marginal individual income tax rate would apply to taxable income over $450,000 for married individuals filing a joint return, $400,000 for unmarried individuals (other than surviving spouses), $425,000 for head of household filers, and $225,000 for married individuals filing a separate return. The income brackets at which this highest rate of tax would apply would be indexed for inflation after the 2022 tax year. However, while the other tax brackets would be indexed for inflation based on calendar year 2017, the top tax bracket’s reference year would be calendar year 2021. While the top marginal tax rate for trusts would also increase to 39.6% from 37%, the taxable income threshold for this tax bracket would be indexed for inflation based on calendar year 2017.

Under the Green Book proposal, the 39.6% rate would have applied in 2022 to taxable income over $509,300 for married individual’s filing jointly, $452,700 for unmarried individuals (other than surviving spouses), $481,000 for heads of household, and $254,650 for married individuals filing separately.

The following table compares the thresholds at which the highest rate of tax would apply to each filing status under current law, the Green Book proposals and the current proposals:

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>JCT Projection for 2022: 37% applicable to income in excess of:</th>
<th>Green Book proposal (2022): 39.6% applicable to income in excess of:</th>
<th>Ways &amp; Means proposal (2022): 39.6% applicable to income in excess of:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Married filing jointly</td>
<td>$646,150</td>
<td>$609,300</td>
<td>$450,000</td>
</tr>
<tr>
<td>Head of household</td>
<td>$538,450</td>
<td>$481,000</td>
<td>$425,000</td>
</tr>
<tr>
<td>Single</td>
<td>$538,475</td>
<td>$452,700</td>
<td>$400,000</td>
</tr>
</tbody>
</table>
The proposal’s reduction of the thresholds at which the top marginal income tax rate would apply would remain in effect for tax years beginning after December 31, 2025. As a result, following the expiration of the tax rates and thresholds in effect for tax years 2018 through 2025 under the TCJA, the 35% bracket would be eliminated for tax years beginning after December 31, 2025, and the remaining rates and thresholds would revert back to levels from prior law in effect before the TCJA (as adjusted for inflation). Thus, whereas under current law the rate brackets are 10%, 12%, 22%, 24%, 32%, 35% and 37%, the rate brackets under the proposal for 2026 and subsequent years would be 10%, 15%, 25%, 28%, 33% and 39.6%.

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

The JCT estimates this proposal would increase revenue by $170.5 billion over the 10-year budget window.

| Married filing separately | $323,075 | $254,650 | $225,000 |

KPMG observation

The increase in the top marginal rate of income tax could have a significant impact on high-income taxpayers. For example, under current law, married taxpayers filing jointly with taxable income of $650,000 in 2021 would pay income tax of $177,023. However, under the proposal, the same amount of taxable income in 2022 would be subject to income tax of $184,343 - an increase of $7,320.

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 proposal would accelerate this expiration date 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 thresholds to the levels that were in effect during the 2013 tax year, without any adjustments for inflation for tax year 2022 and indexing for inflation based on calendar year 2021 for tax years after 2022. Because all other tax brackets, including the 35% tax bracket, are adjusted for inflation based on calendar year 2017, the 35% tax bracket’s taxable income range (the second-highest bracket) would be significantly reduced to pre-TCJA levels.

KPMG observation

While the 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 proposal does not include modifications 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/or phasing out itemized deductions for taxpayers with income over $400,000.
KPMG observation

The proposal does not include repealing or modifying 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, based on the rates JCT projects in the technical explanation, a married couple who each have $300,000 of taxable income would have a federal income tax liability of $157,643 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 ($78,821) if they filed as unmarried single individuals. Thus, under current law, the couple is not subject to an increase in tax as a result of being married and filing a joint tax return (compared to filing as two single individuals).

Under the proposal, based on the rates JCT projects in the technical explanation, the couple would have the same federal income tax liability ($78,821) as under current law if they would each file as single individuals. However, their federal income tax liability would increase to $164,543 if they filed as married filing jointly. Because their federal income tax liability when filing jointly would be more than their combined federal income tax liability when filing as single individuals, they would incur a marriage penalty of $6,900 (the difference between $164,543, their federal income tax liability when filing jointly, and $157,643, their combined federal income tax liability had they not been married and filed as two 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.

KPMG observation

Given the very low threshold for trusts to be in the top income tax bracket, it would continue to be important for trustees to consider making distributions to beneficiaries in lower tax brackets in order to lower the effective tax rate on the trust’s income if such distributions are otherwise consistent with the terms of the trust and the intent of the settlor.
Increase in capital gains rate for certain high-income individuals

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%.

The proposal would increase the top tax rate imposed on long-term capital gains and qualified dividends for individuals, estates, and trusts from 20% to 25% and, effective for tax years beginning after December 31, 2021, lower the income thresholds to which the top rate applies. Thus, if the proposal is enacted, high-income earners would be subject to a maximum income tax rate of 28.8% on their long-term capital gains and qualified dividends when including the NIIT of 3.8%. This rate increase would apply to both the regular tax and the Alternative Minimum Tax (AMT).

The proposal related to the rate increase would generally be effective for tax years ending after September 13, 2021, and thus generally would be effective from January 1, 2021 for calendar year taxpayers (subject to certain transition rules described below).

Importantly, however, the proposal contains a special transition rule for the 2021 tax year in which the proposed maximum tax rate of 25% would only apply to qualified dividends and long-term capital gains realized after September 13, 2021. Qualified dividends and long-term capital gains realized on or before September 13, 2021 would still be subject to the current maximum statutory rate of 20%. A similar transition rule would apply for purposes of the AMT. Furthermore, any gain recognized during 2021 after September 13, 2021, would still be subject to the current maximum statutory rate of 20% if such gain arises from a transaction which occurs pursuant to a written binding contract entered into on or before September 13, 2021, provided the contract is not modified thereafter in any material respect. For purposes of applying this transition rule, for taxpayers with gain or losses from a passthrough entity, the determination of when the gain or loss is taken into account would be made at the entity level.

Prior to TCJA, the maximum capital gains tax rate of 20% applied to taxpayers who were in the highest marginal ordinary income tax bracket (39.6%), as the thresholds for the preferential long-term capital gains brackets conformed to the brackets for ordinary income. However, following the enactment of TCJA, the thresholds for the preferential long-term capital gains brackets do not conform to the brackets for ordinary income for tax years 2018 through 2025.

The proposal would effectively repeal the change made by TCJA that was set to expire after 2025 by once again aligning the maximum capital gain thresholds with the maximum ordinary income tax rate thresholds, with the result that the maximum capital gains rate would only be assessed on taxpayers whose taxable income places them in the highest marginal ordinary income tax bracket.

This proposal would be effective for tax years beginning after December 31, 2021. Thus, since the 39.6% top marginal individual income tax rate for ordinary income would apply to taxable income over $450,000 for married individuals filing a joint return, $400,000 for unmarried individuals (other than surviving spouses), $425,000 for head of household filers, and $225,000 for married individuals filing a separate return, for tax year 2022 under the proposal, taxpayers whose taxable income exceeds the above thresholds during 2022 would also be subject to the top capital gains tax rate of 25% (28.8% including the NIIT) for tax year 2022.

The JCT estimates this proposal would increase revenue by $123.4 billion over the 10-year budget window.
The proposal is a significant deviation from the proposal related to the taxation of long-term capital gains and qualified dividends contained in the Green Book. The Green Book 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. Coupled with the Green Book’s separate proposal that would increase the top ordinary individual income tax rate to 39.6% for tax years beginning after December 31, 2021, a taxpayer with AGI in excess of $1,000,000 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 under the original proposal, a rate that would be the highest in modern times, as well as the highest of any of the 38 OECD member countries.

However, while the maximum tax rate on long-term capital gains and qualified dividends under the current proposal is substantially less (28.8% including the NIIT) than under the Green Book proposal (43.4% including the NIIT), the increased maximum tax rate contained in the current proposal would apply to more taxpayers, especially considering that the current proposal would lower the income threshold to which the maximum rate applies for tax years after 2021, thus compensating for the lost revenue resulting from the lower top rate contained in the current proposal.

Most states do not differentiate between the tax rate applied to capital gains income and ordinary income, meaning that the 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.

**Application of net investment income tax to trade or business income of certain individuals**

**Proposed expansion of application of NII**

Under current section 1411, a tax is imposed on net investment income (“NII”) in the case of certain individuals, estates, or trusts. In general, for individuals, the tax is 3.8% of the lesser of net investment income or the excess of modified adjusted gross income (“AGI”) over a threshold amount. The present threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case. In the case of an estate or trust, the NII tax is 3.8% of the lesser of (1) undistributed net investment income, or (2) the excess of adjusted gross income over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins ($13,050 for tax years beginning in 2021).

Under current law, the NII tax applies if a trade or business is a passive activity with respect to the taxpayer, or if the trade or business consists of trading financial instruments or commodities (as defined in section 475(e)(2)). In general, for a trade or business to be a passive activity with respect to a taxpayer, the taxpayer does not materially participate in the trade or business (within the meaning of section 469, with certain exceptions). Consequently, the NII tax generally does not apply to income or gain from a trade or business conducted as a sole proprietor, partnership, or S corporation, if the individual taxpayer
materially participates in the trade or business activity.

The proposal would provide that a high-income individual (determined based on specified, filing-status-based amounts, listed below) would be subject to NII tax on net income or net gain regardless of whether the taxpayer materially participates in a trade or business that generated the net income or net gain, when such net income or net gain is not otherwise subject to the Federal Insurance Contribution Act (FICA) or the Self-Employment Contributions Act (SECA) regimes.

For taxpayers subject to the proposal, the proposal would expand the definition of net investment income subject to the NII tax. Specifically, in the case of any individual who has modified AGI in excess of the income threshold amounts, the NII tax of 3.8% would apply to the greater of “specified net income” or net investment income (as defined under present law). In the case of an estate or trust, the NII tax would be 3.8% of the lesser of (1) the greater of “undistributed specified net income” or undistributed net investment income (also, as defined under present law), or (2) the excess of adjusted gross income over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins.

Under the proposal, specified net income would be specified income reduced by the deductions properly allocable to such income. Specified income would be the sum of (i) gross income from interest, dividends, annuities, royalties, and rents, (ii) other gross income derived from a trade or business, and (iii) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property (when all of the above would be considered as specified income, regardless of material participation).

**Income thresholds and phase-in of increase**

Under the proposal, the income threshold amount would be $500,000 in the case of a joint return or surviving spouse, $250,000 in the case of a married individual filing a separate return, and $400,000 in any other case. The increase in tax under the proposal would be phased in based on a ratio of (i) the excess of the taxpayer’s modified AGI over the applicable high income threshold amount to (ii) $100,000 (one-half of such amount in the case of a married taxpayer filing separately). Under this phase-in approach, if a married individual who files a joint return would have modified adjusted gross income of, for example, $540,000, the increase in tax under the proposal would be limited to 40% ($540,000 - $500,000 / $100,000) of the increase that would be determined in the absence of the phase-in limitation. The proposal would retain the unindexed threshold amounts above which the NII tax would apply, specifically, $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case.

**NII clarification elements**

The proposal also would provide several clarifications regarding the determination of net investment income. First, the proposal would clarify that net investment income would not include wages subject to FICA tax. Second, the proposal would clarify that deductions properly allocable to investment income in determining net investment income would not include net operating loss deductions under section 172. Finally, the proposal would provide that net investment income would include subpart F and GILTI inclusions in respect of stock of a CFC and QEF inclusions in respect of stock of a PFIC. It would codify the existing regulatory treatment of mark-to-market inclusions in respect of PFIC stock as net investment income.

The proposal would provide that the Treasury Secretary shall issue regulations or other guidance providing for the treatment of distributions of amounts previously included in gross income for purposes of chapter 1 but not previously subject to NII tax. The proposal also would provide that the Secretary shall
issue regulations or other guidance to include transition rules for coordination with existing inclusion rules under the proposal for subpart F and GILTI inclusions in respect of stock of a CFC and inclusions in respect of stock of a PFIC.

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

The JCT estimates this proposal would increase revenue by approximately $252.2 billion over the 10-year budget window.

**KPMG observation**

The principal effect of the proposal would be that S corporation shareholders, limited partners, and LLC members over a certain income threshold—who currently may not be liable for FICA or SECA or NII tax, on their pro rata shares, distributive shares, and partnership income and gain—would potentially be subject to NII tax on this income and gain.

**KPMG observation**

The proposal is a departure from the approach adopted in the Biden Administration’s Green Book which had proposed to subject the distributive share of S corporation income to SECA taxes. Under current law, the wage income of an S corporation shareholder is subject to FICA taxes, to the extent of reasonable compensation paid, but an S corporation shareholder’s distributive income would not be subject to SECA taxes. Under the Green Book proposal, the distributive share of materially participating high-income shareholders would have been subject to SECA taxes. Under the Ways and Means proposal, there is not a suggested change to subject the income of S corporation shareholders to SECA taxes. However, to the extent an S corporation shareholder might have income which exceeds the stated thresholds noted above, then the taxpayer would be subject to NII on such income, regardless of material participation.

**KPMG observation**

The proposal is also a departure from the approach adopted in the Green Book which had proposed to modify the limited partner exception, to increase the application of SECA taxes for high earners. Under current law, a limited partner is subject to SECA tax only to the extent the partner receives guaranteed payments for services. The limited partner’s distributive share of income or loss is excluded. Under the Green Book proposal, the limited partner exception would have only applied in cases when a limited partner was not a high-income taxpayer or did not materially participate in the activity. Under the Ways and Means proposal, there is not a suggested change to modify the limited partner exception. However, to the extent a partner (including a limited partner) might have income which exceeds the stated thresholds noted above, then the taxpayer would be subject to NII on such income, regardless of material participation.

**KPMG observation**

The proposal also does not apply the expansive self-employment “doughnut hole” provision that had been part of President Biden’s proposals during his presidential campaign. The doughnut hole
provision would have subjected all wages and certain partnership income to the full amount of FICA (12.4%, with employee share of 6.2%) or self-employment (12.4%) for earners making over $400,000.

Limitation on deduction of qualified business income for certain individuals

Section 199A permits a non-corporate taxpayer a potential deduction of up to 20% of the taxpayer’s “combined qualified business income,” subject to a limitation of 20% of the taxpayer’s overall taxable income (reduced by net capital gain defined under section 1(h)). “Combined qualified business income” generally includes the taxpayer’s share of qualified business income with respect to qualified trades or businesses and the taxpayer’s share of qualified REIT dividends and qualified publicly traded partnership income. The deduction amount attributable to the taxpayer’s qualified business income may be subject to limitations based on W-2 wages and capital investments for taxpayers over a certain taxable income threshold.

The proposal would generally impose an additional dollar limitation on a taxpayer’s aggregate deduction such that the amount of deduction for any tax year may not exceed $500,000 for a married filing joint return or surviving spouse, $250,000 for a married individual filing a separate return, $10,000 for an estate or trust, or $400,000 for any other taxpayer. These threshold amounts would not be indexed for inflation.

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

The JCT estimates this proposal would increase revenue by approximately $78 billion over the 10-year budget window

KPMG observation

The proposal essentially creates a fixed cap on the deduction for qualified business income under section 199A(a) for a given tax year, for taxpayers. The present-law phaseouts of the deduction above the threshold amount would continue to apply, subject to this additional limitation.

KPMG observation

If this proposal is enacted as proposed, a taxpayer with significant qualified business income – who expects to have such benefit limited under this proposal – could have an incentive to accelerate income in the current year (assuming it is otherwise appropriate to do so, including from a time value of money perspective). Under the proposal, qualifying income generated in 2021 may generally be taxed for federal purposes at a rate of 29.6% (37% less 20% benefit for 199A deduction) as compared to income earned in 2022, or later, whereby such income may be taxed at a number which is trending to an effective tax rate in excess of 46% (i.e., 39.6% less capped 199A benefit, plus potential 3.8% NIIT and potential 3% surcharge).

For example, assume a taxpayer (married, filing jointly) has qualifying business income of $50 million for 2021 (for which such taxpayer materially participates in the underlying activity). If the taxpayer can maximize the benefit of section 199A with respect to such income, the tax on the income in 2021 would approximate $14.8 million (37% of $40 million ($50 million less $10 million deduction under section 199A)), for an effective tax rate of 29.6%. However, now assume the
same taxpayer earns qualifying business income of $50 million in 2022 and the proposal above is enacted. Even if the taxpayer could maximize the benefit of section 199A with respect to such income, the tax on the income would approximate $23 million (39.6% of $50 million less $500,000, plus 3.8% NIIT, and 3% surcharge, on $50 million), for a potential effective tax rate in excess of 46%. This would represent a potential increase in effective tax rate from 2021 to 2022 which exceeds 16.4%.

**KPMG observation**

If allowed under the terms of a trust arrangement, and all else equal, a trustee or executor may consider distributing out of the trust the business interest generating the qualified business income to the beneficiary to take advantage of the higher dollar limitation afforded to individual taxpayers.

### Limitations on excess business losses of noncorporate taxpayers

In general, the section 461(l) excess business loss limitation limits the extent to which trade or business losses of a noncorporate taxpayer may be used to offset other income of the taxpayer. The excess business loss limitation is calculated by taking the aggregate deductions attributable to trades or businesses over the sum of aggregate gross income or gain attributable to trades or businesses, plus an annual threshold amount. Under current law, any excess business loss which is suspended is carried over to the taxpayer’s next tax year as a net operating loss (NOL). Currently, the excess business loss limitation regime is set to sunset, such that losses will no longer be limited after December 31, 2026.

The proposal would remove the provision’s present sunset date and make the excess business loss limitation permanent. Significantly, the proposal would also change the manner in which the excess business loss is carried over to a subsequent year. Under the proposal, instead of the excess business loss becoming an NOL in the taxpayer’s following year, the excess business loss would become a deduction attributable to a trade or business loss which would be subject to the section 461(l) limitation in the taxpayer’s subsequent tax year.

The limitation on excess farm losses under section 461(j) would also be repealed under this proposal.

This proposal would apply for tax years beginning after December 31, 2020.

The JCT has estimated this proposal would increase revenue by approximately $166.8 billion over the 10-year budget window.

**KPMG observation**

The proposal represents a substantial change to the manner in which the excess business loss regime currently operates. By modifying the provision to have excess business losses “re-tested” in the taxpayer’s subsequent tax year—as compared to treating as an NOL in the following year—a taxpayer’s ability to claim trade or business deductions could be significantly limited.

Net operating loss deductions for tax years beginning after December 31, 2020 are limited to 80% of taxable income and can generally offset any type of income. In contrast, if the loss is required to be re-tested, it may take many more years for the taxpayer to be able to utilize the benefit of such losses. Further, if a taxpayer might have consecutive years of excess business losses, the
KPMG observation

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

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

KPMG observation

The proposal has a retroactive effective date for tax years beginning after December 31, 2020. As a result of the CARES Act, section 461(l) was set to have application to non-corporate taxpayers for tax years beginning after December 31, 2020. Presumably, this retroactive date is designed to harmonize the changes of the proposal with the effective commencement date of section 461(l), post-CARES Act. However, taxpayers who may have planned for the eventual utilization of excess business losses in 2021 under current law (i.e., through an NOL in 2022) could have to reconsider certain planning for 2021, to the extent the proposal might curtail the utilization of excess business losses expected from 2021 (i.e., through the taxpayer’s 2022 excess business loss calculation, under the proposal).

Surcharge on high-income individuals, trusts, and estates

Currently, there is no separate income tax surcharge levied on individuals, estates, or trusts with income above certain levels.

The proposal would impose a new 3% income tax surcharge on individuals, estates, and trusts with MAGI above a certain threshold, which would apply in addition to any other applicable income tax. This new surcharge would apply to MAGI in excess of $5,000,000 for taxpayers who file as single, head of household, or married filing jointly; $2,500,000 for taxpayers who file married filing separately; and $100,000 for estates and trusts.

For purposes of this proposed surcharge, an individual’s MAGI would be the individual’s AGI reduced by any deduction (not taken into account in determining AGI) allowed for investment interest. Estates and trusts would be subject to the 3% surcharge once their modified adjusted gross income (MAGI) exceeds $100,000. MAGI is adjusted gross income (AGI) reduced by (1) deductions for expenses specific to trusts or estates, (2) the income distribution deduction, (3) the personal exemption, and (4) any deduction for investment interest.
Special rules would apply to certain individuals and trusts. Nonresident aliens would be subject to the 3% income tax surcharge only on income that is effectively connected with the conduct of a trade or business within the United States, less any deductions allocable to this effectively connected income. For U.S. citizens and residents living abroad, the applicable MAGI threshold at which the surcharge applies would be reduced by any amounts excluded under section 911 (the foreign earned income and housing exclusion), less any deductions or exclusions allocable to amounts excluded under section 911. Additionally, certain charitable trusts would not be subject to the proposed surcharge.

Under the proposal, the income tax surcharge would not be considered in determining the amount of any income tax credit (including the foreign tax credit), or in determining the amount of any credit for AMT purposes.

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

The JCT estimates this proposal would increase revenue by $127.3 billion over the 10-year budget window.

**KPMG observation**

The surcharge income tax to be imposed on high-income earners could mean a heavier tax burden for international assignees subject to tax in the United States.

**KPMG observation**

Given the lower threshold for trusts and estates to be in the surcharge bracket, it may become increasingly important for trustees to consider making distributions to beneficiaries who would not be subject to the surcharge in order to lower the effective tax rate on the trust’s income if such distributions are otherwise consistent with the terms of the trust and the intent of the settlor.

**Termination of temporary increase in unified credit**

The TCJA temporarily doubled the gift, estate, and generation-skipping transfer tax exclusion amount (used to determine the unified credit) from $5,000,000 to $10,000,000. This $10,000,000 amount is indexed for inflation occurring after 2011 such that the exclusion for estates of decedents dying and gifts made in 2021 is $11,700,000. This temporary increase is scheduled to expire on December 31, 2025.

The proposal would accelerate the expiration of the temporary increase in the exclusion for estates of decedents dying and gifts made after December 31, 2021. As a result, the exclusion amount would revert to $5,000,000 indexed for inflation after 2011; with indexing, it is anticipated that the exclusion for 2022 would be $6,020,000.

The JCT has estimated that the provision would increase revenues by approximately $54.3 billion over 10 years.

**KPMG observation**

The proposal would give individuals until the end of the year to take advantage of the enhanced
exclusion amount by making gifts (in trust or otherwise). However, if the proposed changes to the treatment of grantor trusts (see discussion below) are adopted, appreciation on any assets contributed to grantor trusts after the date of enactment would be included in the donor’s estate at death (eliminating one of the advantages of making gifts during life). Thus, if a grantor trust is the intended recipient of the remaining exclusion amount, there may be a more limited window of time in which to act.

KPMG observation

It is interesting to note that there were no transfer tax proposals included in the Green Book but there are four transfer tax proposals in the Chairman’s amendment (see discussions below). These transfer tax proposals may have been included as an alternative to the Green Book proposal to treat gifts, bequests, and transfers to trusts as deemed realization events.

KPMG observation

As a reminder, Treasury and the IRS published final regulations on November 26, 2019 that prevent the benefit of the higher exclusion amount from being “clawed back” if the exclusion is lower at the date of death than at the date of gift. As such, taxpayers who utilize the increased exclusion amount prior to the end of the year should not lose that benefit in the event the proposal is enacted.

KPMG observation

The generation-skipping transfer tax (GSTT) is a separate tax that can apply in addition to either the gift tax or the estate tax. The GSTT exemption, however, is set by reference to the gift and estate tax lifetime exclusion. As such, when the exclusion decreases, the GSTT exemption also is reduced.

KPMG observation

In addition to making new gifts before year end to utilize as much of their currently available gift tax exclusion and GSTT exemption as possible, individuals could also consider allocating some or all of their remaining GSTT exemption to any pre-existing trusts that are not already exempt from GSTT.

Increase in limitation on estate tax valuation reduction for certain real property used in farming or other trades or businesses

As a general rule, the value of property included in a decedent’s estate for estate tax purposes is its “fair market value.” Section 2032A allows the estate to elect to value certain real property used in farming or other trades or businesses at its current use (rather than other more valuable uses the property might be put to in the hands of a willing buyer). Under current law, the allowed valuation reduction (attributable to value at current use) is limited to $750,000 (or $1,190,000, as adjusted for inflation to 2021).
The proposal would increase the permitted valuation reduction to a maximum of $11,700,000 (indexed for inflation).

This provision would be effective for estates of decedents dying after December 31, 2021.

The JCT has estimated that the provision would decrease revenues by approximately $317 million over 10 years.

KPMG observation

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

KPMG observation

For some qualifying farmers and small business owners dying after December 31, 2021, the increased valuation reduction of up to $11,700,000 (indexed for inflation) could allow them to retain the benefit of the current estate tax exclusion amount, in addition to the benefit of the reduced $6,020,000 estate tax exclusion amount after year end.

Certain tax rules applicable to grantor trusts

If a grantor establishes a trust and retains certain enumerated benefits in or powers over the trust, the trust is treated as a “grantor trust” for federal income tax purposes and all trust income is taxable to the grantor. However, the current rules regarding what qualifies as a completed transfer for income tax purposes and for estate tax purposes are not identical. Because of these differences, an irrevocable trust can be structured so its assets are excluded from the grantor’s estate (and considered completed gifts) but its income is still taxed to the grantor (as if the gift had not been made). Such trusts are commonly referred to as intentionally defective grantor trusts (“IDGTs”). These differences in income tax and transfer tax treatment allow the trust assets to grow for the benefit of future generations undiminished by income tax (because the tax liability associated with such growth is paid by the grantor of the trust rather than the trust itself) while also removing appreciation and income attributable to the assets gifted or sold to the trust from the grantor’s estate for estate tax purposes.

A trust that is not treated as separate from the grantor for income tax purposes has another advantage - sales of appreciated assets by the grantor to the trust are ignored for income tax purposes and generate no capital gain. Nor does a sale to the trust result in gift tax liability, as the transfer of assets to the trust is for full and adequate consideration.

The proposal makes significant changes to the transfer tax and income tax treatment of grantor trusts including IDGTs. The changes would apply to trusts created on or after the date of enactment and to any portion of a previously established trust which is attributable to contributions made after that date.
The JCT has estimated that the provision would increase revenues by approximately $7.9 billion over 10 years.

**Transfer tax aspects of proposal.** Any portion of a trust with respect to which the grantor is treated as the owner under the grantor trust rules (generally by virtue of a retained power over or beneficial interest in the trust) is included in the grantor’s gross estate at death. In addition, any distribution from a grantor-owned portion of a trust to a beneficiary (other than the grantor or their spouse) is treated as a gift made by the grantor. If the grantor ceases to be the owner of a portion of a trust during the grantor’s life, the grantor is treated as making a gift of the assets attributable to that portion of the trust. The proposal would allow for an adjustment to amounts included in the grantor’s estate or treated as gifted by the grantor to account for amounts previously treated as taxable gifts. The transfer tax proposal does not apply to trusts that would be included in the gross estate without regard to the proposal.

KPMG observation

The transfer tax aspects of the proposal only appear to apply to grantor trusts when the grantor is the owner under the grantor trust rules. The proposal does not appear to alter the gift and estate tax treatment of trusts that are owned by one or more beneficiaries because of withdrawal rights or otherwise.

KPMG observation

The proposal provides no details with respect to how the “adjustment” made to amounts subject to estate or gift tax to account for amounts previously subjected to gift tax would be calculated. It is possible the amount subject to transfer tax at the time of subsequent estate inclusion or gift would simply be reduced by the amount treated as a taxable gift at the time the grantor trust was created or funded.

KPMG observation

As discussed, the proposal appears to subject the grantor to transfer tax on any appreciation on the assets gifted to a grantor trust at the time of a distribution from the trust, upon cessation of grantor trust status during life, or at the death of the grantor. When the grantor is not also a beneficiary of the relevant trust, the grantor would have to pay the tax with other assets, potentially creating a liquidity problem.

KPMG observation

Although the exception for trusts that would already be included in the gross estate of the grantor under current law would seem to clearly contemplate revocable trusts, it would also seem to except irrevocable trusts in which the grantor has retained various rights or control. For example, a grantor retained annuity trust (“GRAT”) is includable in the grantor’s estate because of the retained annuity; thus, a GRAT may not be subject to the proposed changes until after the annuity term. If the GRAT or any trust to which the remainder pours over at the end of the term simultaneously becomes or already is a non-grantor trust, it is possible that the proposal would have no transfer tax impact on the estate planning benefits of GRATs.
KPMG observation
If this proposal is enacted, it may no longer make sense to use grantor trusts for estate planning purposes. While many trusts used for wealth transfer planning can fairly easily be drafted to avoid grantor trust status, it may be more difficult with others. For example, spousal limited access trusts are typically grantor trusts because the grantor’s spouse is one of the beneficiaries (as the name implies); going forward, such trusts would potentially need to utilize an adverse trustee to maintain non-grantor trust status. In addition, irrevocable life insurance trusts (“ILITs”) are typically grantor trusts because insurance premiums can be paid with trust income; if the proposal is enacted, such trusts may need to prohibit use of income for that purpose. For existing ILITs, when additional contributions will be required in order for the trust to make ongoing premium payments, consideration should be given to pre-funding such trusts with premium payments prior to the date of enactment to avoid estate inclusion or gift tax consequences associated with the ILIT in the future.

KPMG observation
Contributions to grantor trusts (whether newly created or pre-existing) made before date of enactment would not be subject to the transfer tax (nor income tax) treatment outlined in the proposal. Thus, individuals may wish to consider establishing such trusts or making such contributions in the near term. This may be advantageous even if the donor has already utilized their gift tax lifetime exclusion and would have to pay gift tax.

KPMG observation
Given that the proposal would apply to a portion of a trust attributable to contributions made to that trust after the date of enactment, it would be important to confirm the status of any existing trusts for income tax purposes and avoid making any post-enactment date contributions to any trusts that appear to be owned by the grantor. Since the status of a trust as grantor-owned or non-grantor is not always crystal clear, it may make sense to create new non-grantor trusts rather than risk causing complications for pre-existing trusts.

KPMG observation
The proposal does not include a definition of “contribution” when indicating that it would apply to contributions made to grantor trusts after the date of enactment. However, the common understanding of a contribution to a trust is a gift or gratuitous contribution. Thus, it is possible that a sale of appreciated assets to an existing IDGT would not be viewed as a contribution, increasing the transfer (and income) tax benefits of having an IDGT in place before the date of enactment.

KPMG observation
It is not clear whether the proposal applies—and if so, how—to a trust that starts out as a non-
grantor trust but subsequently becomes a grantor trust. This can sometimes happen even inadvertently, such as when there is a change in trustee (e.g., from independent to related or from adverse to non-adverse). In this scenario, would a trust that was thought to be excluded from the estate of the grantor unexpectedly become includable and subject to estate tax? If so, then the proposal would make it even more important to carefully monitor any changes to the trust or the identity of the individuals involved in the trust operations to avoid such inadvertent grantor trust classifications and resultant transfer tax issues.

**KPMG observation**

The proposal does not specifically address the application of GSTT. Under current law, when a grantor sets up an IDGT, it is possible to allocate GSTT exemption to the trust such that it is potentially exempt from transfer tax for the duration of the trust. Consistent with the treatment of a distribution or cessation of grantor trust status as a taxable gift and subjecting the trust to estate tax at the grantor’s death, it would seem logical that the trust would lose its fully exempt status (unless the grantor allocated additional GSTT exemption) at those junctures. If this is the correct interpretation of the proposal, it would be yet another reason that grantor trusts would no longer make sense for estate planning purposes.

**Income tax aspects of proposal.** For purposes of determining whether a sale or exchange has taken place for income tax purposes when property is transferred between a trust and the owner of the trust under the grantor trust rules, the treatment of the deemed owner as the income tax owner of the trust would be disregarded. As a result, a sale of assets by the deemed owner to his or her grantor trust would now be a recognition event. Losses attributable to such a sale would generally be disallowed under Section 267(b) to which a new category of related persons—a trust and the trust’s owner under the grantor trust rules—would be added. The income tax proposal does not apply to trusts that are fully revocable.

**KPMG observation**

It seems fairly clear that the income tax part of the proposal would cause a grantor to recognize gain on the sale of appreciated assets to an IDGT for a promissory note. In addition, while not free from doubt, given the application of the proposal to “any transfer of property between a trust” and its deemed owner, it seems likely that a substitution or swap of the grantor’s assets for assets of the trust would similarly result in a sale or exchange with corresponding recognition of gain by the parties.

**KPMG observation**

The income tax aspects of the proposal appear to apply more broadly than the transfer tax aspects - to any owner of a trust under the grantor trust rules, not just the creator of the trust. Thus, the income tax consequences would seem to be relevant to a beneficiary owner (under section 678) who transfers property to the trust in a sale or exchange transaction as well.
In the context of a sale to an IDGT for a promissory note, the interest payments made by the IDGT to the grantor owner are not subject to income tax given the trust’s grantor trust status. The proposal does not appear to impact the treatment of those interest payments.

Valuation rules for certain transfers of nonbusiness assets

The gift tax and estate tax apply to the fair market value of the property being transferred on the date of transfer. The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. The fair market value of an interest in an entity may be less than the owner’s proportionate share of the value of the entity’s assets because of lack of control and/or lack of marketability; thus, discounts for lack of marketability and/or lack of control have historically been applied when valuing such interests.

The proposal would eliminate these types of discounts for certain “nonbusiness assets” by treating any such assets as if they had been transferred directly instead of as a part of an entity. Nonbusiness assets are defined as any passive asset held for the production or collection of income, but which is not used in the active conduct of a trade or business. There is an exception provided for assets needed for working capital and hedging transactions. If the entity holds as a passive asset a 10% or greater interest in any other entity, the proposal includes a look-through rule treating the assets in that lower entity as being held directly by the top entity. This rule is applied successively to any 10% interest in another entity held by any lower tier entities.

The proposal would apply to transfers made after the date of enactment.

The JCT has estimated that the provision would increase revenues by approximately $19.9 billion over 10 years.

KPMG observation

Previous attempts at eliminating valuation discounts on interests in entities, such as the previously proposed section 2704 regulations, have focused on family ownership and control of the entity. This proposal focuses instead on the nature of the assets owned by the entity as active or passive so could apply to entities controlled by third parties.

KPMG observation

The working capital exception would require taxpayers to carefully assess the reasonably required working capital needs of an operating business and may require certain judgment calls as to what is reasonable, pending any further guidance.

KPMG observation

It appears that valuation discounts might still be permissible for certain nonbusiness assets if, were they transferred directly and not as part of an entity, they would nonetheless be encumbered by
Modification of rules relating to retirement plans

Contribution limit for individual retirement plans of high-income taxpayers with large account balances

The proposal would create a new section 409B that would prohibit annual additions to various retirement plans, including IRAs and defined contribution plans, for a high-income individual with an aggregate accumulation in applicable retirement accounts of at least $10 million. This limitation would only apply to an individual with adjusted taxable income that exceeds $400,000 in a year, joint taxable income of $450,000, or $425,000 in the case of an individual who is a head of household. The proposal defines adjusted taxable income for this purpose as taxable income determined without regard to any deduction for annual additions to which proposed section 409B(a) applies, and any increased in minimum required distributions (as amended by the proposal).

The proposal would apply to a “applicable retirement plan,” which includes a defined contribution plan under section 401(a) or section 403(a), an annuity under section 403(b), or deferred compensation under section 457(b) maintained by a State or agency or instrumentality or political subdivision of a State, and an individual retirement plan. Both the account limit and the income amounts would be subject to cost-of-living adjustment after 2022.

Certain contributions are not considered an annual addition for purpose of section 409B, including contributions to SEP and SIMPLE plans, rollover contributions, and accounts acquired by death, divorce, or separation.

The proposal would provide that, if a prohibited annual addition were made to an IRA, an excise tax would apply.

There is proposed to be a new information reporting requirement for high account balances. If at the end of any plan year, 1 or more participants in an applicable retirement plan have a vested account balance of at least $2,500,000, the plan administrator would be required to file a statement which includes the name of participant, identifying number of the participant, and the amount the participant is entitled. The vested account balance amount would be subject to inflation adjustment after 2022.

These changes are proposed to apply to tax years beginning after December 31, 2021. The information reporting would apply to plan years beginning after December 31, 2021.

The JCT estimate of the revenue impact of this proposal has been combined with the JCT-provided estimate for the proposal below.

Increase in minimum required distributions for high-income taxpayers with large retirement account balances

The proposal would require distributions from retirement account balances in excess of $10 million for individuals with adjusted taxable income in excess of $400,000, joint income of $450,000, or $425,000 for head of household. Adjusted taxable income for this purpose would be defined in proposed section 409B, discussed above. All qualified retirement plans and eligible deferred compensation plans would be treated as one plan for purposes of this proposal.
The increase in the minimum required distributions (MRDs) for the tax year is the excess of (a) the sum of (1) the “applicable Roth excess amount” (Roth amounts in excess of $20 million, indexed) plus (2) 50% of the aggregate vested retirement plan balance that exceeds $10 million (indexed) reduced by the applicable Roth excess amount over (b) the sum of the minimum required distributions (determined without regard to this proposal) for all such plans.

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

Under the proposal, distributions would not be eligible for rollover distributions.

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

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

These provisions are proposed to be effective for tax years and plan years beginning after December 31, 2021.

The JCT has estimated that this this proposal, together with the proposed contribution limit for individual retirement plans of high-income taxpayers with large account balances, would increase revenue by approximately $1.8 billion over the 10-year budget window.

KPMG observation

There has been much publicity recently regarding MEGA IRAs. It was not surprising to see a variety of limits imposed on both contributions, investments, and required distributions. Due to the $10 million threshold, the contribution and distribution requirements would not likely affect the majority of retirement plan participants.

Tax treatment of rollovers to Roth IRAs and accounts

The proposal would eliminate a conversion from a traditional IRA to a Roth IRA for any taxpayer with adjusted taxable income that exceeds $450,000 for a joint return, $400,000 for an individual return, or $425,000 for head of household. Adjusted taxable income for this purpose would be defined in proposed section 409B, discussed above.

Further, the same individuals would be unable to convert amounts held in non-Roth defined contributions plans, such as 401(k) plans, 403(b) arrangements, and governmental section 457(b) plans, to a designated Roth account. The proposal would prohibit all after-tax amounts held in non-Roth account in an employer-sponsored retirement plan or a traditional IRA from being converted to a Roth IRA or a designed Roth account. This part of the proposal would apply to distributions, transfers, and contributions made in tax years beginning after December 31, 2031.

The proposal would prohibit all after-tax amounts held in non-Roth account in an employer-sponsored retirement plan or a traditional IRA from being converted to a Roth IRA or a designed Roth account and would apply to distributions, transfers, and contributions made after December 31, 2021.
The JCT estimates this proposal would increase revenue by approximately $749 million over the 10-year budget window.

**KPMG observation**

The use of the “back door” conversion is a common retirement planning tool for participants unable to make direct Roth IRA contributions. This proposal would affect many more individuals than the contribution and distribution provisions for the large retirement account balance proposals.

**Prohibition of IRA investments conditioned on account holder’s status**

Under current law, taxpayers can direct their Individual Retirement Accounts (IRA) to invest in unregistered securities, such as private placements, hedge funds, and private equity funds. These investments are generally only available to accredited investors. Individuals qualify as accredited investors by meeting one of the following requirements:

- Specified minimum amount of income or net worth,
- Specified minimum level education, or
- Holding a specific license or credential.

Generally, accredited investors that are not institutional are high-net-wealth individuals meeting the income/net worth test. IRAs can then be directed to invest in the unregistered securities to defer income taxation on the gains or potentially exempt the gains from taxation entirely by investing through Roth IRAs.

The proposal would disqualify IRAs from holding investments when the taxpayer must qualify under the tests listed above. Under the proposal, an account would lose its IRA status as of the first day of the tax year that the IRA held unregistered securities. It is important to note that, under the proposal, an IRA already holding such investments would not be grandfathered in, but instead would have a two-year transition period to dispose of the securities or lose its IRA status after December 31, 2023.

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

The JCT has estimated this proposal would increase revenue by approximately $1.7 billion over the 10-year budget window.

**KPMG observation**

The proposal would prevent high-net-worth individuals with privileged access to unregistered securities from using IRA accounts to either defer or avoid income taxation on capital gains from these investments that, if not shielded, would be subject to the increased top marginal income tax rate and capital gains rate proposed by this proposal.

**Statute of limitations with respect to IRA noncompliance**

The proposal would extend the statute of limitations (SOL) from three to six years for additional tax assessments on prohibited transactions and erroneous information reporting relating to investment valuation in an IRA.
This proposal is retroactive and would extend the SOL to six years for taxes with respect to which the three-year SOL ends (without regard to the amendment made by this proposal) after December 31, 2021.

The JCT has estimated this proposal would increase revenue by approximately $8 million over the 10-year budget window.

Prohibition of investment of IRA assets in entities in which the owner has a substantial interest

The proposal would prohibit IRA funds from being invested in interests that are not readily tradable on an established market if the IRA owner owns 10% or more of the entity (directly or indirectly) or held by the IRA. An interest is measured by 1) combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock in a corporation, 2) the capital interest or profits interest in a partnership, and 3) the beneficial interest in a trust or estate. Further, the proposal would prohibit an IRA from investing in an entity if the IRA owner were an officer or director of the entity. If an IRA invested in these prohibited assets, the IRA would cease to be an IRA on the first day of the tax year.

Constructive ownership rules would apply. An individual would be treated as owning interests held by certain family members, including a spouse, ancestors, lineal descendants, and spouses of lineal descendants.

The proposal would apply for investments made in tax years beginning after December 31, 2021. If an IRA holds a prohibited investment on the date of enactment, the proposal would apply to those investments for tax years beginning after December 31, 2023.

The JCT has estimated this proposal would increase revenue by approximately $42 million over the 10-year budget window.

IRA owners treated as disqualified persons for purposes of prohibited transaction rules

While an Individual Retirement Account (IRA) is generally exempt from taxation, an IRA can cease to be an IRA if it engages in certain transactions, known as prohibited transactions, with a disqualified person.

Under current law, a disqualified person includes:

1) A fiduciary of the plan;
2) A person providing services to the plan;
3) An employer with employees covered by the plan;
4) An employee organization any of whose members are covered by the plan;
5) A direct or indirect owner of an interest of 50% or more in the employer or employee organization; or
6) A corporation, partnership, or trust or estate of which (or in which) an interest of 50% or more is held directly or indirectly by a person described in (1), (2), (3), (4) or (5).

Furthermore, the following transactions, whether direct or indirect, between a plan and a disqualified person are considered prohibited transactions:

1) The sale, exchange, or leasing of property;
2) The lending of money or other extension of credit;
3) The furnishing of goods, services, or facilities;
4) The transfer to, or use by or for the benefit of, a disqualified person, the income or assets of the plan;
5) In the case of a fiduciary, any act that deals with the plan’s income or assets for the fiduciary’s own interest or account; and
6) The receipt by a fiduciary of any consideration for the fiduciary’s own personal account from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.

Proposal

The proposal would amend the definition of a disqualified person by providing that an IRA owner is a disqualified person with respect to the IRA. In addition, the following would be treated as disqualified persons under the proposal:

1) A family member of the IRA owner;
2) A corporation, partnership, or trust or estate in which an interest of 50% or more is held directly or indirectly by the IRA owner; and
3) A 10% or more (in capital or profits) partner or joint venturer of the IRA owner.

The proposal would apply to transactions occurring after December 31, 2021.

The JCT has estimated this proposal would increase revenue by approximately $13 million over the 10-year budget window.

Funding the IRS

Almost 96% of the gross revenue of the United States flows through the IRS, resulting in $3.5 trillion in gross taxes collected. IRS Publication 4450, Congressional Budget Justification & Annual Performance Report and Plan, Fiscal Year 2022, p.5 (May 2021). According to the Technical Explanation, the IRS received only $11.9 billion in congressional appropriations for fiscal year 2021, which was spent as follows: $2.6 billion on taxpayer services, $5.2 billion on enforcement, $3.9 billion on operations support, and $223 million for modernization of business systems. Almost all the IRS’s operating costs are funded by congressional appropriations.

The proposal would provide $79.5 billion in additional funding to the IRS, Treasury Inspector General for Tax Administration (TIGTA), and the U.S. Tax Court to enhance tax administration and improve voluntary compliance. The additional funding would be over the 10-year budget window commencing with fiscal year 2022 until fiscal year ending September 30, 2031.

First, the proposal would provide approximately $79 billion of additional funding to enable the IRS to strengthen its enforcement functions, increase voluntary compliance, and modernize information technology. The proposal would direct that additional resources go toward enforcement against those with the highest incomes, rather than taxpayers with taxable income below $400,000.

Second, the proposal would provide an additional $410 million to TIGTA to facilitate oversight of the IRS, including ensuring taxpayer privacy and that no undue burden is imposed on small businesses from IRS enforcement.
Third, the proposal would provide an additional $157 million to the U.S. Tax Court for adjudicating tax disputes.

These proposals would be effective upon enactment.

Estimates of the revenue impact of this proposal will be provided by the Congressional Budget Office.

KPMG observation

This proposal would represent a very significant increase in funding intended to provide the IRS with a sustained investment in the improvement of its overall performance. In the short run, however, the proposed increase in funding might place a strain on current IRS operations as the organization manages its multiple ongoing challenges while it simultaneously recruits, hires, trains and assimilates large numbers of new employees, and modernizes its computer systems.

The Congressional Budget Office (CBO) has not published an official score of the estimated budgetary effects for this proposal as of the date of this publication. It is possible the official score would not include revenue raised by the proposed increase in funding given current budget rules (even though there may be an “unofficial” analysis projecting possible increased revenue for informational purposes). CBO has published its estimate of revenues for the President’s 2022 Budget based on the IRS’s projected returns on investment (ROIs) for spending on new enforcement initiatives. See Publication 57444, “The Effects of Increased Funding for the IRS,” Congressional Budget Office (Sept. 2, 2021). The IRS provided ROIs over the past five years as part of its budget justification. The IRS’s ROIs ramp up over three years as staff become trained and fully productive. In recent years, a $1 increase in spending on the IRS’s enforcement activities results in $5 to $9 of increased revenues.

Backup withholding and third party networking

The proposal would amend section 3406(b) by adding certain payments made in settlement of third party network transactions to the list of reportable payments subject to backup withholding. Specifically the proposal would provide that a reportable payment that may trigger a backup withholding requirement includes any payment in settlement of a third party network transaction when either: 1) The aggregate amount of such payment and all previous such payments made by the third party settlement organization (TPSO) to the participating payee during such calendar year equals or exceeds $600 (the “$600 de minimis threshold”); or 2) the TPSO was required to file a return under section 6050W for the preceding calendar year with respect to payments made to the participating payee.

This proposal would apply to calendar years beginning after December 31, 2021. However, the proposal includes a transition rule for 2022 which provides that backup withholding for TPSOs that exceed the $600 de minimis threshold would apply only when the aggregate number of third party network transactions settled by the TPSO with respect to the participating payee during 2022 exceeds 200 transactions.

The JCT has estimated that the proposal would lose approximately $4 million over a 10-year period.
KPMG observation

The $600 de minimis threshold for backup withholding on section 6050W transactions provided for under the proposal is consistent with the modified de minimis thresholds that were introduced for section 6050W reporting purposes under the enactment of ARPA in March 2021. Currently, TPSOs are only required to report for section 6050W purposes when the total amount of the payments to the participating payee exceeds $20,000 in value and the aggregate number of transactions exceeds 200. The modifications enacted under ARPA, scheduled to go into effect for calendar years beginning after December 31, 2021, reduce the de minimis threshold amount for section 6050W reporting to $600, with no limitation regarding the number of transactions. Therefore, after calendar year 2022, the de minimis rules for reporting and backup withholding under section 6050W will be consistent if the proposal is passed into law.

It is notable, however, that if the proposal were to be adopted in its present form, reporting and withholding for section 6050W purposes for calendar year 2022 would not be consistent. Reporting under section 6050W for calendar year 2022 would follow the $600 de minimis threshold, with no limitation on transactions, while backup withholding would apply only after both the $600 de minimis threshold and the 200-transaction thresholds were reached. This proposed transitional backup withholding rule for calendar year 2022 is unusual in that it is neither consistent with the current reporting rule (pre-2022) nor the new reporting rule set to go into effect after December 31, 2021.

Limitation on deduction for qualified conservation contributions made by passthrough entities

The proposal would deny a charitable contribution deduction for contributions of conservation easements by partnerships and other pass-through entities if the amount of the contribution (and therefore the deduction) exceeded 2.5 times the sum of each partner’s adjusted basis in the partnership that relates to the donated property. This general disallowance rule would not apply to donations of property that meet the requirements of a three-year holding period rule. The proposal also includes an exception for certain family partnerships.

Various accuracy-related penalties would apply to any underpayment of tax attributable to a disallowance of a deduction by reason of this proposal, including a gross valuation misstatement penalty. The proposal would also make adjustments to the statute of limitations on assessment and collection by the IRS, in case of any disallowance of a deduction by reason of this provision.

In addition, the proposal would allow certain taxpayers an opportunity to correct certain defects in a deed that grants an easement—in particular, defective language in the deed relating to property line adjustments or extinguishment clauses that the Secretary determines causes a failure to meet the requirement that a qualified conservation easement be granted and protected in perpetuity. The donor would have 90 days from the written notice by the Secretary to correct the defects, unless the Secretary could demonstrate that the donor’s failure was intentional. The ability to cure would not apply to any transaction that is a reportable transaction or any other contribution for which a deduction is disallowed under the proposal described above.

This section would generally apply to contributions made after December 23, 2016, though, in the case of contributions of easements related to the preservation of certified historic structures, it would apply to contributions made in tax years beginning after December 31, 2018. The ability to cure defective deeds would be permitted for returns filed after the date of the enactment of the provision and for returns filed on or before such date if the statute of limitations has not expired as of that date.
The JCT has estimated that the proposal would raise approximately $12.5 billion over a 10-year period.

**KPMG observation**

The transactions that would give rise to a disallowance of a charitable contribution deduction under this proposal are similar, but not identical, to the listed transactions described in Notice 2017-10, which was issued on December 23, 2016. As a result, the proposal would generally be retroactively effective for tax years beginning after December 23, 2016, even though some transactions might be disallowed under the provision that were not described in Notice 2017-10. For example, Notice 2017-10 required a marketed transaction; the legislative proposal, by contrast, is not limited to contributions for which the investor received promotional materials that offered the possibility of a charitable contribution deduction equaling or exceeding 2.5 times the amount of the investor’s investment.

**Modify requisite supervisory approval for penalty assessments**

Section 6751(b)(1) requires 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 most penalties imposed under the Code, except: 1) failure-to-file and failure-to-pay penalties under section 6651; and 2) failure to pay estimated tax penalties under sections 6654 (individuals) and 6655 (corporations). Other penalties exempt from the pre-approval requirement are penalties that are automatically calculated through electronic means. The section 6751(b) supervisory approval requirement not only applies to the assessment of penalties but also to the assessment of additions to tax. Section 6751(c).

Notwithstanding that taxpayers have the initial burden of proof in any court proceeding with respect to the liability of any penalty under the Code, Section 7491(a), Section 7491(c) provides that the IRS has the burden of production with respect to the liability of any penalty. In other words, the IRS has the burden to present sufficient evidence showing that it is appropriate to impose the relevant penalty. Because the IRS has the burden of production in penalty cases, the IRS’s compliance with procedural requirements is an essential part of this burden. Therefore, the IRS must produce evidence of compliance with the supervisory approval requirement.

Courts have considered taxpayer arguments that the IRS failed to obtain supervisory approval prior to assessing a penalty. The court decisions have addressed, among other issues, the timing of the requisite supervisory approval, who must sign the approval, and which penalties require approval. The JCT technical explanation asserts that these court decisions have led to uncertainty regarding the application of section 6751(b). According to the Technical Explanation, “[r]esulting litigation has established varying benchmarks or ‘consequential moments’ for determining whether the IRS has satisfied the requirements.” This could result in the IRS obtaining the required supervisory approval prior to the time a supervisor may have all the information relevant to a decision whether a penalty is appropriate.

The proposal would repeal the requirement for prior supervisory approval of penalties before assessment by the IRS set forth in current law section 6751(b), effective as if included in the Internal Revenue Service Restructuring and Reform Act of 1998, section 3306 (Pub. L. 105-206). In its place, the proposal mandates that appropriate IRS supervisors certify quarterly to the Commissioner that the penalty notices issued by their employees are in compliance with the statutory requirements of section 6751(a) and related policies of the IRS.
The quarterly certifications proposal would be effective for all notices of penalties issued after date of enactment.

The JCT has estimated that the proposal would raise approximately $1.4 billion over a 10-year period.

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. By eliminating the initial supervisory approval, the proposal appears to undercut that original purpose.

Other proposals

Modifications to limitation on deduction of excessive employee remuneration

Under section 162(m)(1), a deduction limit of $1 million generally applies to compensation paid to covered employees (the principal executive officer, principal financial officer, and the three most highly compensated executive officers for the tax year). The American Rescue Plan Act of 2021 (ARPA) expanded the set of applicable employees under section 162(m) to include an additional “five highest compensated employees” beyond those already covered by section 162(m), beginning in tax years after December 31, 2026.

This proposal would accelerate the timing of ARPA’s changes to section 162(m) so that the additional five would be included for tax years beginning in 2022.

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

The JCT has estimated this proposal would increase revenue by $16.9 billion over the 10-year budget window.

KPMG observation

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

The additional covered employees are determined on an annual basis and not subject to the “once covered, always covered” perpetuity rule. However, it is unclear how the perpetuity rule would interact with the “annual five” rule, with some interpreting the provision as permitting the
perpetual covered employees to be counted toward the annual five and others viewing the five as additive rather than inclusive.

A carryover question from ARPA remains how compensation is determined for identifying the covered employees and whether the SEC definition of “compensation” will drive the analysis.

Companies would generally need to include the impact not only on tax returns going forward, but also in their audited financials and associated provisions on or after the date of enactment. Companies often coordinate the section 162(m) covered employee determination in conjunction with proxy disclosures. However, that process is often limited to SEC defined executive officers and may not be well suited to identify covered employees, which appears broader than “executive officers” for this purpose. As a result, many taxpayers may need to quickly consider what could be the impact to their deferred tax assets without the benefit of guidance to address these and other open questions.

Extension of tax to fund Black Lung Disability Trust Fund

In general, a tax is imposed on coal from mines located in the United States. The proposal would extend the temporary increased excise tax rates of $1.10 per ton for coal from an underground mine or $0.55 per ton for coal from a surface mine. The total amount of tax is not to exceed 4.4% of the price at which such ton of coal was sold by the producer. The tax funds the Black Lung Disability Trust Fund.

The extension of the tax would be effective through December 31, 2025.

The JCT estimates this proposal would increase revenue by approximately $536 million over the 10-year budget window.

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

The U.S. tax system has had a series of special tax regimes intended to provide incentives for foreign trade, including the DISC regime and foreign sales corporations (FSC). The proposal would amend the definition of prohibited transaction under section 4975 to include an IRA holding an interest in a DISC or FSC that receives any commission or payment from an entity any stock or interest in which is owned by the individual for whose benefit the IRA is maintained. If the IRA holds an interest in an entity that owns any interest in a DISC or FSC, the account would be treated as holding an interest in the DISC or FSC.

The proposal generally would apply to stock and other interests acquired or held on or after December 31, 2021.

The JCT estimates this proposal would increase revenue by approximately $1.9 billion over the 10-year budget window.

Increase in tax on certain tobacco products and imposition of tax on nicotine

An excise tax is currently imposed on manufacturers and importers of specified tobacco products. Effective for articles removed during calendar quarters beginning after the date of enactment, the proposed legislation would:

- Double the current rate of excise taxes on
- Small cigarettes to $100.66 per thousand,
- Large cigarettes to $211.39 per thousand,
- Small cigars to $100.66 per thousand, and
- Roll-your-own tobacco (including certain processed tobacco) to $49.56 per pound.

- Increase tax on smokeless tobacco as follows
  - Snuff to $26.84 per pound, and
  - Chewing tobacco to $10.70 per pound.

- Increase tax on pipe tobacco to $49.56 per pound

Effective for articles removed during calendar quarters beginning 180 days after the date of enactment, the proposed legislation would:

- Change the tax on large cigars to $49.56 per pound, but not less than 10.06 cents per cigar,

- Add a new tax on discrete single-use units of smokeless tobacco (defined as any product containing tobacco that is not intended to be smoked, such as a lozenge, tablet, pill, pouch, dissolvable strip, or other discrete single-use or single-dose unit) at the rate of $100 per thousand, and

- Impose excise taxes on “taxable nicotine” (defined as any nicotine, other than nicotine used in specified listed tobacco products, that has been extracted, concentrated, or synthesized, such as nicotine used in vaping) at a rate of $100.66 per 1,810 milligrams of nicotine.

The manufacturer of taxable nicotine (that is, any person who extracts, concentrates, or synthesizes nicotine) would be subject to the occupational tax and other requirements that apply to manufacturers of tobacco products. The proposed legislation would treat taxable nicotine as a tobacco product that is subject to existing rules regarding purchase, receipt, possession, sale, and packaging of tobacco products, as well as civil and criminal penalties. Exemptions would apply to nicotine that meets certain approvals by the Food and Drug Administration (“FDA”), such as for certain nicotine replacement therapy. A transition rule would apply to permit requirements for manufacturers of tobacco products in certain situations.

The proposed legislation would require the Secretary to promulgate regulations to coordinate the provisions and avoid double taxation.

The proposal would impose a floor stocks tax on certain specified tobacco products removed and held for sale upon the effective date of the provision in an amount equal to any tax already imposed on the product and the new tax rate. The floor stocks tax would apply to products in foreign trade zones in certain situations.

All tax rates listed above would be indexed for inflation annually beginning in 2023.

The JCT estimates this proposal would increase revenue by approximately $96.8 billion over the 10-year budget window.
30 states, the District of Columbia, Puerto Rico, and some cities and counties currently impose tax on vapor products.

Clarification of tobacco drawback rules

Federal excise taxes are imposed on manufacturers and importers of certain goods, such as wine, beer, distilled spirits, tobacco, and petroleum products. Upon exportation of these type of goods, in certain cases a “substitution drawback” on the taxes, fees, and duties paid on imports may be allowed when other merchandise is exported, whether or not certain taxes were paid on the corresponding exported merchandise.

Effective December 18, 2018, the proposed legislation would provide that certain exemptions from the section 5701 tax imposed on tobacco products, cigarette papers, and tubes would be treated as a drawback and no further drawback would be allowed based on exported merchandise that has not been subject to tax.

The proposed legislation states that no inference may be made from this clarification with respect to any drawback claim made before December 18, 2018.

The JCT included the estimate of the budgetary impact of this proposal with the estimate provided above regarding the taxation of certain tobacco products and nicotine.

KPMG observation

The proposed legislation addresses “substitution drawbacks” that may result in payment of “double drawbacks” that are allowed with respect to certain exported products on which no tax was imposed. The Federal Circuit Court of Appeals recently affirmed the Court of International Trade on this issue in a taxpayer favorable opinion related to exported alcohol. The clarification and no inference language would remove the applicability of that opinion to tobacco products.

Repeal employer credit for paid family and medical leave

Section 45S currently allows a credit for employers providing paid family and medical leave. The Taxpayer Certainty and Disaster Tax Relief Act of 2020 extended the employer credit through December 31, 2025.

The proposal would terminate the credit under section 45S on December 31, 2023.

The JCT estimates this proposal would increase revenue by approximately $642 million over the 10-year budget window.

KPMG observation

In order to be eligible for the credit under section 45S, an employer had to offer paid FMLA leave to all employees, including part-time employees. As paid FMLA leave for all employees is not common, the availability of this credit was limited.
Access to self-employment income information for paid leave administration

The proposal would amend section 6103(l) of the Code by adding a new section 6103(l)(23) to allow for disclosure of certain information to carry out the paid family and medical leave benefit program. The proposal would provide that the Secretary shall disclose, upon written request, to officers and employees within the Treasury Department return information of a taxpayer whose self-employment income is relevant in determining eligibility for, or the correct amount, of a paid family leave and medical leave benefit proposed to be established under title XXII of the Social Security Act.

As explained in the section-by-section summary, the provision would authorize such disclosures for purposes of administering the paid family and medical leave program proposed to be established in other parts of budget reconciliation legislation.

The proposal would limit the return information subject to disclosure to:

1) Taxpayer identity information,
2) The self-employment income of the taxpayer, and
3) The tax year to which such self-employment income relates.

Return information disclosed under the provision could be used by officers and employees of the Treasury Department solely for the purpose of administering the paid family and medical leave benefit program proposed to be created under title XXII of the Social Security Act. For purposes of the provision, “self-employment income” would have the meaning given such term in section 1402(b) for purposes of the taxes imposed by section 1401(b).

The JCT estimates this proposal would have no impact on revenue over the 10-year budget window.

Temporary rule to allow certain S corporations to reorganize as partnerships without tax

The proposal includes a provision that generally would allow certain electing S corporations to convert from a corporation to a domestic partnership for federal tax purposes without the recognition of gain or loss, during 2022 and 2023.

Specifically, if enacted, the proposal would provide that a qualified liquidation of an eligible S corporation would be treated for federal tax purposes in the same manner as if—(i) the liquidation were a complete liquidation described in section 332(b); and (ii) the “domestic partnership” referred to in the bill were a corporation which is an 80% distributee (within the meaning of section 337(c) of the Code). The net result of these provisions generally should be a tax-free liquidation of the corporation (followed by a formation of the new partnership). However, the proposal would apply to a qualified liquidation only if the eligible S corporation elects application of the proposed legislation in the manner required by the Secretary (but filed not later than the due date for filing the S corporation’s return for the tax year in which the liquidation is completed).

For this purpose, the proposal defines an “eligible S corporation” as any corporation (including any predecessor corporation) that was an S corporation on May 13, 1996, and at all times thereafter through the date on which the qualified liquidation is complete. Further, the term “qualified liquidation” would mean one or more transactions occurring during the two-year period beginning on December 31, 2021 if—(i) such transactions would constitute the complete liquidation of an eligible S corporation; and (i) substantially all of the assets and liabilities of the eligible S corporation would be, as a result of those...
transactions, transferred to a domestic partnership.

In the case of any qualified liquidation to which the proposal applies, the domestic partnership that survives the reorganization would be treated as a successor corporation for purposes of section 1362(g) (which restricts the ability of a corporation to make an S election for any tax year before its fifth tax year that begins after the first tax year for which the termination is effective). The proposed legislation would grant the Secretary authority to prescribe the regulations or other guidance necessary or appropriate to carry out the section.

The JCT has estimated this proposal would decrease revenue by approximately $4.8 billion over the 10-year budget window.

KPMG observation

In general, an S corporation’s conversion to a partnership is a taxable transaction, treated as though (i) the S corporation transferred its assets to its shareholders (subject to its liabilities) in liquidation of the S corporation, followed by (ii) the contributions by those shareholders of their proportionate shares of the S corporation’s assets (subject to their proportionate shares of the liabilities) to a new partnership in exchange for interests in the partnership. The S corporation recognizes gain and loss on its assets in the deemed liquidation, which is passed through to and allocated among the corporation’s shareholders. Each shareholder is treated as receiving its proportionate share of the S corporation’s assets (subject to liabilities), and recognizes gain or loss in its S corporation stock based on the difference between the net fair market value of the property received and the adjusted basis in the S corporation stock surrendered, as adjusted to account for the shareholder’s share of any gain or loss recognized by the S corporation on the liquidation. This potential gain recognition may be a significant impediment to a conversion.

The proposed provision would allow an eligible S corporation to reorganize as a partnership without recognizing gain at either the corporate or the shareholder level. Through operation of the existing federal tax laws, after the conversion the partnership would have a basis in its assets that generally would equal the corporation’s pre-conversion basis in those assets. This would be expected to be beneficial for an eligible S corporation with significant built-in gain that would like to convert to a partnership.

KPMG observation

Limitations contained in the proposal could prevent many S corporations from taking advantage of its provisions. First, an eligible S corporation would be required to complete the conversion within the two-year period beginning on December 31, 2021 (i.e., during the 2022-2023 period). Thus, the corporation would need to make the decision to convert to a partnership and accomplish all transactions necessary to do so in a relatively short period of time. More importantly, however, the tax-free conversion would be available only to an S corporation that existed and was an S corporation on May 13, 1996 and at all times thereafter until completion of the liquidation. Thus, S corporations that were formed after that date (or existed but had not yet elected S status on that date) or whose S corporation status was interrupted would not be eligible for the benefit.

Questions have been raised as to the choice of May 13, 1996 as the applicable date to limit S corporations eligible for the tax-free reorganization. The section-by-section explanation notes that such date was the date “prior to the publication of current law ‘check the box’ regulations with
respect to entity classification.” Presumably the intent is to allow the benefit for entities formed on or before that date as those entities may have felt “trapped” into S corporation status because – (i) the owners wanted limited liability while participating in management; and (ii) prior to publication of the check the box regulations, the entity may not have qualified for partnership classification under the four-factor entity classification regulations then in effect. If that was indeed the motivation, some revision to the May 13, 1996 date may be warranted. The prescribed date is the date the check the box regulations were proposed – not the date on which they were finalized or effective. Thus, entities formed between May 13, 1996 and the January 1, 1997 effective date of the check the box regulations presumably could have also been considered for tax-free conversion.

KPMG observation

The proposal raises additional considerations as to the impact of the conversion on Qualified Subchapter S Subsidiaries (QSUBs) which might be held by the eligible S corporation, upon conversion. Additional consideration would need to be afforded to the impact of such conversion on section 1374 (built in gains tax), as well as with respect to the treatment of entity-level attributes of the S corporation, upon conversion (e.g., Accumulated Adjustments Account (AAA), Accumulated Earnings and Profits (AE&P), Previously Taxed Income (PTI), and Excess Business Interest Expense (EBIE) carryovers under Section 163(j), among other entity-level attributes).

KPMG observation

From a state perspective, some states adopt a fixed, prior version of the Code, and this type of state’s legislature would need to take action to adjust the conformity to the current Code before this federal change would be adopted. If a particular state were to not adopt the proposed change, then the S Corporation may be required to recognize gain in that state.

Treatment of certain qualified sound recording productions

The proposed legislation would add “qualified sound recording productions” to the list of items eligible for the expensing election under section 181. The amount of such recording costs eligible for expensing in any tax year would be limited to $150,000. For purposes of the proposal, qualified sound recordings would be works resulting from the fixation of a series of musical, spoken, or other sounds, regardless of the nature of the material objects, in which they are embodied. Sounds accompanying a motion picture or other audiovisual work would not be eligible under the proposal. The proposed legislation limits the eligibility of sound recordings for expensing under section 181 to recordings produced and recorded in the United States.

The proposed legislation would also make qualified sound recording productions eligible for the additional first year depreciation deduction (“bonus depreciation”) of section 168(k). Under that section, qualified property is eligible for bonus depreciation in the year it is placed in service. Pursuant to the proposed legislation, a qualified sound recording production would be placed in service in the tax year of its initial release or broadcast.

The proposed legislation would be effective for productions commencing after the date of enactment.

The JCT estimates this proposal would decrease revenue by approximately $35 million over the 10-year
Payment to certain individuals who dye fuel

In general, tax is imposed by section 4081 upon the removal of taxable fuel (including diesel fuel and kerosene) from a terminal. If tax is paid on more than one taxable event for a taxable fuel, the person paying the “second tax” on such fuel may claim a refund (without interest) of that second tax if certain conditions and reporting requirements are met. However, the removal of diesel fuel and kerosene that is indelibly dyed and removed for nontaxable purposes is not subject to tax.

Effective with respect to indelibly dyed diesel fuel or kerosene that is removed on or after 180 days after the date of enactment, the proposed legislation would create a refund mechanism for previously-taxed fuel that is removed for specified nontaxable uses. The claimant would be the person that removes the previously taxed, indelibly dyed fuel. Additional conditions to allowance would apply.

The JCT has estimated this proposal would decrease revenue by approximately $4 million over the 10-year budget window.

KPMG observation

The new refund mechanism would address a situation in which tax-paid fuel is used in a nontaxable use, but for which no claim for refund is currently allowable. For example, if fuel is removed from a terminal, taxed, and then transported by truck to a second terminal, the tax imposed upon removal from the second terminal is the “second tax” and the person who paid the second tax may make a claim a refund under section 4081(e). Under current law, if the fuel is dyed upon removal from the second terminal, there is no refund allowable because there is no “second tax” paid on the dyed fuel.

Extension of credit for portion of employer Social Security taxes paid with respect to employee tips to beauty service establishments

Employee tip income is treated as wages and is deemed paid by the employer for FICA tax purposes. Under current section 45B, employers that operate food and beverage establishments are eligible for a nonrefundable tax credit equal to an employer’s FICA taxes paid on tips in excess of those treated as wages for purposes of meeting the minimum wage requirements of the Fair Labor Standards Act (FLSA). The proposal would extend the credit to beauty service businesses. Beauty service would be defined as barbering and hair care, nail care, esthetics, and body and spa treatments.

The amendments made by the proposal would apply to tax years beginning after December 31, 2021.

The JCT estimates this proposal would decrease revenue by approximately $711 million over the 10-year budget window.

Enhancement of work opportunity tax credit during COVID-19 recovery period

The work opportunity tax credit (WOTC) is available on an elective basis for employers hiring individuals from one or more of ten targeted groups. The amount of credit available is based on the amount of qualified wages paid by the employer. Qualified wages consist of wages attributable to services rendered
by a member of a targeted group during the first year of employment and generally the credit is equal to 25-40% depending on the numbers of hours worked by eligible workers during the year.

The proposal would increase that amount of the WOTC to 50% for the first $10,000 in wages, through December 31, 2023, for all WOTC targeted groups except summer youth employees. The 50% credit also would be available for qualified wages earned by a WOTC targeted group employee in his or her second year of employment.

The proposal would apply to tax years ending after the date of enactment.

The JCT estimates this proposal would decrease revenue by approximately $6.1 billion over the 10-year budget window.

**Allowance of deduction for certain expenses of the trade or business of being an employee (union dues)**

Prior to 2018, union dues were deductible as a miscellaneous itemized deduction, subject to a 2% of AGI limitation. Under current law, all miscellaneous itemized deductions, including unreimbursed employee expenses such as union dues, are suspended for tax years 2018 through 2025.

The proposal would allow union dues (not in excess of $250) to be deducted as an above-the-line deduction in arriving at AGI if a taxpayer paid dues to a labor organization and remained a member through the end of the tax year.

The proposal would be applicable to tax years beginning after December 31, 2021.

The JCT estimates this proposal would decrease revenue by $4.25 billion over the 10-year budget window.

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**KPMG observation**

The proposal would allow more workers to deduct union fees regardless of whether they choose to claim the standard deduction or itemized deductions. In addition, as an above-the-line deduction, union dues would not be subject to the 2% of AGI limitation imposed on miscellaneous itemized deductions, and thus would not subject to the TCJA’s suspension of miscellaneous itemized deductions for tax years 2018 through 2025.

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**Repeal limitation on cover over of rum taxes to Puerto Rico and U.S. Virgin Islands**

In general, distilled spirits brought into the United States from Puerto Rico and the U.S. Virgin Islands are subject to an equalization tax of $13.50 per proof gallon, which is collected by the U.S. Treasury. The revenues from these taxes, to the extent attributable to rum, are transferred (“covered over”) to the Treasuries of Puerto Rico and the U.S. Virgin Islands, subject to certain limitations. The proposal would:

- Repeal a limitation on the amount of distilled spirits tax covered into the treasuries of Puerto Rico and the U.S. Virgin Islands, and
- Require a specified amount of such tax covered over into the treasury of Puerto Rico to be transferred to the Puerto Rico Conservation Trust Fund.
In general, the proposal would be effective with respect to distilled spirits brought into the U.S. after December 31, 2021.

In addition, under the proposal, the cover over amounts on the equalization tax on rum from Puerto Rico and the Virgin Islands and the tax on imported rum would be determined without regard to volumetric reduced rates or refunds in lieu of reduced rates, effective as of January 1, 2021 (the effective date of the Craft Beverage Modernization Act, which was included in the Taxpayer Certainty and Disaster Tax Act of 2020).

The JCT has estimated that the proposal would lose approximately $1.9 billion over a 10-year period.

**Delay in mandatory capitalization of research and experimentation costs**

The TCJA changed section 174 for tax years beginning after December 31, 2021 so that research and experimentation costs would be subject to mandatory capitalization. U.S. based R&E activities would be capitalized and amortized over a five-year period beginning with the midpoint of the tax year in which the R&E costs were paid or incurred. This period is 15 years if the R&E activities are not in the U.S. or a possession of the U.S. The TCJA also contained a conforming amendment to the definition of “qualified research” in section 41(d)(1)(A).

The proposal would delay implementation of these changes by four years so that the amortization of research and experimental expenditure would begin for amounts paid or incurred in tax years beginning after December 31, 2025.

The JCT estimates this proposal would decrease revenue by $4 billion over the 10-year budget window. However, the JCT estimates that the proposal would decrease revenues by $125.2 billion during the period of 2022-2025 (the dates for which the delay would be effective).

**KPMG observation**

There has been much focus in Washington in recent months on a variety of proposals to incentivize increased research and experimentation within the United States in a number of industries. The delaying of the effective date or the complete repeal of the section 174 capitalization changes enacted in the TCJA appears to have a degree of bipartisan appeal.

**Payroll credit for compensation of local news journalists**

The proposal would allow an eligible local newspaper publisher a refundable credit against employer Medicare taxes for each calendar quarter up to 50% of applicable wages in the first four quarters and 30% of applicable wages in a fifth quarter. Applicable wages could not exceed $12,500.

An eligible local news publisher would be any employer if substantially all of the gross receipts of the employer for the quarter are derived in the trade or business of publishing local newspapers. Aggregation rules under section 52(a) and (b) and section 414 (m) and (o) apply to treat as one employer, unless such persons are not involved in the production of the same print or digital publication.

A local newspaper would include any print or digital publication, but 1) must be primarily original context from primary sources and relates to new and current events, 2) the publication supports the needs of a
regional or local community, 3) the publisher employs at least one local news journalist who lives in the region or local community, and 4) the publisher cannot employ more than 750 employees.

An eligible local news journalist would have to provide at least 100 hours of service in such role each quarter. Service includes the individual gathers, collects, photographs, records, writes, or reports news or information regarding local events and matters of local interest.

The credit would not be allowed for the U.S. government or any agency or instrumentality.

The proposal would be effective for the first five quarters after date of enactment.

The JCT estimates this proposal would decrease revenue by $1.3 billion over the 10-year budget window.

Treatment of financial guaranty insurance companies as qualifying insurance corporations under passive foreign investment company rules

The proposal would expand the active insurance company exception under the passive foreign investment company (PFIC) rules—sections 1297 through 1298. Generally, a PFIC is a foreign corporation that has, during the tax year, at least 75% passive income or an average percentage of assets that produce passive income of at least 50%. Passive income is any income of a kind that would be foreign personal holding company income as defined in section 954(c), subject to certain exceptions in the PFIC rules.

One exception from the definition of passive income is income derived in the active conduct of an insurance business by a qualifying insurance corporation (QIC), which was modified in the TCJA.

Current law section 1297(f) provides that a QIC is a foreign corporation that (1) would be subject to tax under subchapter L if it were a domestic corporation, and (2) either (A) has applicable insurance liabilities (“AIL”) constituting more than 25% of its total assets on its applicable financial statement (the 25% test), or (B) meets an elective alternative facts and circumstances test which lowers the AIL ratio to 10% (alternative facts and circumstances test).

Generally, applicable insurance liabilities are limited to loss and loss adjustment expenses and life and health insurance reserves. The proposal would provide that, for entities that meet the definition of a financial guaranty insurance company, unearned premium reserves would be included within the definition of applicable insurance liabilities. In addition, the proposal would provide statutory support for the regulatory provision that a financial guaranty insurance company would be treated as satisfying the alternative facts and circumstances test (assuming an AIL ratio of at least 10% and being predominantly engaged in an insurance business). Treas. Reg. 1.1297-4.

This provision is generally proposed to be effective for tax years beginning after December 31, 2017.

The JCT has estimated that the proposal would lose approximately $74 million over a 10-year period.
capital requirements for these entities are geared towards ensuring sufficient capital in times of crisis, financial guaranty companies may require higher capital requirements. In the preambles to the proposed and final PFIC regulations, Treasury recognized that financial guaranty insurance may require special rules, but, ultimately, felt that the proposals to allow unearned premiums to be included under the 25% test were contrary to the statute and intent of Congress. This proposal would provide an industry favorable expansion of the QIC exception to the PFIC rules.

Credit for qualified access technology for the blind

Under current law, an individual who is blind is allowed to claim the basic standard deduction plus an additional standard deduction amount. For 2021, this additional amount is $1,350 for a married taxpayer (in the case of a joint return, each spouse who is blind is eligible for this additional amount), and $1,700 for single individuals and heads of households.

The proposal would create a new temporary refundable credit for tax years 2022 through 2025 for amounts paid or incurred during the tax year by a taxpayer for qualified access technology (e.g., technology that translates visual information into formats that are useable by blind individuals) for use by a qualified blind individual. The proposal defines a qualified blind individual as including the taxpayer, the taxpayer’s spouse, or any dependent who meets the definition of blind for purposes of the additional standard deduction amount.

The proposal would limit the amount of the credit allowed with respect to any qualified blind individual to $2,000 in any consecutive three-year period. This amount would be adjusted for inflation for tax years after 2022. Any expenses reimbursed by insurance would be ineligible for the credit.

The proposed credit would be effective for tax years beginning after December 31, 2021, and would not apply with respect to amounts paid or incurred in tax years after December 31, 2026.

The JCT estimates this proposal would decrease revenue by $3.5 billion over the 10-year budget window.

KPMG observation

Similar versions of the proposed credit were introduced in 2019 and in January of 2021 as the Access Technology Affordability Act. If enacted, the credit would improve affordability of access technology important for employment and independent living for individuals who are considered to be blind.

Modification of REIT constructive ownership rules

This proposal would eliminate so-called “double downward” attribution that can, in certain circumstances, result from the application of constructive ownership rules applicable to REITs. Solely for purposes of the REIT rules, a person treated as owning an interest in a corporation or other person (such as a partnership) as a result of the application of attribution rules under section 318(a)(3) (as modified by section 856(d)(5)) would not be treated as owning that interest for purposes of applying section 318(a)(3) to attribute that interest to another person.

The JCT has estimated that the proposal would have a revenue cost of less than $500,000.
The proposal would apply to tax years ending after the date of enactment.

The JCT estimates this proposal would decrease revenue by less than $500,000 over the 10-year budget window.

**KPMG observation**

These constructive ownership rules are primarily relevant for purposes of determining if a particular tenant is related to a REIT or if a particular person qualifies as an “independent contractor” of a REIT. This provision would, if enacted, simplify that analysis.

**KPMG observation**

Note that a proposal discussed earlier in this report would allow taxpayers to elect to monetize certain renewable energy credits without a corresponding reduction in actual tax liability, applicable to assets placed in service after December 31, 2021. Historically, many REITs have been unable to take full advantage of certain federal tax credit provisions, given that REITs typically do not have a tax liability that can be reduced by the credit.

**State and local tax implications**

As taxpayers prepare to assess the potential impact of the proposed legislation 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 proposed legislation with respect to 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 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 proposed legislation in some areas is 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 proposed legislation.

It may well take a few years for states to formulate policies around, and enact laws conforming to, or decoupling from, the proposed tax changes. Even now, almost four 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, would 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 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 adjourn by July 1 each year. Depending on when a new federal law is enacted and the effective dates of the provisions, 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 GILTI in state taxable income.

Finally, the extent to which a particular state would 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 additional federal tax reforms. 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 analyzing and modeling of the enacted changes in a careful manner, 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 automatically 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 likely would continue to be consequential given the proposed legislation 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 generally have no direct effect on state tax liabilities. One might be tempted to ask whether the proposed increase in the federal corporate rate from 21% to 26.5% 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 local fiscal conditions, comparisons with surrounding states, and political preferences of policy makers than by the federal tax rate.

**SALT considerations of the proposed legislation**

At first glance, the provisions in the proposed legislation that potentially could have significant state implications are the changes to the international provisions included in the TCJA and the adoption of a new, additional limitation on the deductibility of interest expense under IRC section 163(n). The proposed changes to GILTI include accelerating the reduction of the section 250 deduction from 50% to 37.5%, reducing the percentage for measuring deemed returns to QBAI from 10% to 5%, and computing GILTI on a country-by-country basis. There are also proposals to accelerate the reduction of the FDII deduction to 21.875% and to make both the GILTI and FDII deductions eligible to create a net operating loss carryforward. Another change in the proposed legislation would revise the BEAT regime; that change likely would have few direct state consequences. Finally, the proposed legislation would adopt additional limitations on the deductibility of interest expenses under a new section 163(n).

This change also could create interesting state issues.

**GILTI:** Currently, under section 951A, U.S. shareholders of CFCs must include in federal taxable income an amount computed by reference to 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 U.S. Shareholder (e.g., 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 U.S. Shareholder’s GILTI inclusion (subject to limitation when GILTI exceeds the U.S. Shareholder’s 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 because states do not have a foreign tax credit equivalent.

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 proposed changes to the GILTI regime would include a reduction of the section 250 deduction from 50% to 37.5% of GILTI (potentially raising the effective U.S. income tax rate on GILTI to 16.5625% given the proposed 26.5% corporate 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 proposed legislation would also reduce the deduction of QBAI from 10% to 5% of a CFC’s tangible assets when computing GILTI and would 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 until future legislation is enacted, GILTI would be computed under the existing rules of the TCJA, which allow for a QBAI deduction at 10% and do not require a jurisdiction-by-jurisdiction calculation method. 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 when 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 currently 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 percentage 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 and allow 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 proposed legislation would retain the FDII deduction but would accelerate the reduction of the deduction to 21.875% (this is currently scheduled to occur for tax years beginning after December 31, 2025). Rolling conformity states that allow a FDII deduction would automatically adopt the reduction. Static conformity states that allow a FDII deduction would continue to allow the deduction at 37.5% until they adopted legislation advancing the state’s conformity. In both rolling and static conformity states that require a separate company computation of the FDII deduction, differences may exist from the deduction computed for federal purposes under the consolidated return regulations.

Section 250 deduction can create a federal NOL: Currently, under section 172(d)(9), the deductions for GILTI and FDII cannot create a net operating loss. Under the proposed legislation, if the section 250
deduction with respect to GILTI or FDII exceeds taxable income, the excess is allowed as a deduction, which would increase the net operating loss for the tax year. Application at the state level would likely depend on whether the state conforms to the proposed change, adopts GILTI and/or FDII and the extent to which the state adopts or incorporates the federal NOL. As a result, in many states, a GILTI or FDII deduction that creates a net operating loss under the proposed amendment may not create a state net operating loss. This creates the potential for surprise in the future when corporations may have significant federal net operating loss carryforwards to offset federal taxable income, but still have significant state taxable income because of lack of conformity by some states not conforming to this new provision.

Revising BEAT: The proposed legislation would make numerous changes to the BEAT regime, including raising the rate and revising the rules for determining modified taxable income. The BEAT is structured as a separate minimum tax that currently has almost no direct effect on the states because it does not generally affect the calculation of federal taxable income, which serves as the starting point for computing state taxable income for most state corporate income taxes. 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.

While BEAT is a separate tax, certain taxpayers have elected to waive certain deductions to mitigate the BEAT liability, which can result in increased state taxable income. The proposed legislation would likely have minimal direct impact on states, as the BEAT continues to be structured as a separate minimum tax. However, the increased BEAT rate and expansion of payments potentially subject to the BEAT may cause taxpayers to consider waiving more deductions to avoid becoming subject to the BEAT. Waiving these deductions could increase the state taxable income and associated state liabilities for those taxpayers.

Further restrictions on deductibility of interest: In addition to maintaining the TCJA changes to section 163(j), the proposed legislation provides for new limitations on the deductibility of interest expense under proposed section 163(n). Under the proposed legislation, the interest expense deduction of a “specified domestic corporation” that is a member of an international financial reporting group cannot exceed the “allowable percentage” of 110% of the corporation’s net interest expense. A specified domestic corporation means any domestic corporation whose average excess interest expense over interest includible in income over a three-year period exceeds $12,000,000. All domestic corporations that are members of the same international financial reporting group are treated as a single corporation for purposes of determining whether a corporation is a specified domestic corporation subject to proposed section 163(n).

A specified corporation’s allowable percentage (not to exceed 100%) is the ratio of the corporation’s share of the financial reporting group’s net interest expense reported in the financial reporting group’s financial statements over the corporation’s reported net interest expense. A domestic corporation’s allocable share of the group’s net interest expense is the portion of such expense which bears the same ratio to the total group expense as the corporation’s EBITDA bears to the group’s total EBITDA.

The proposed legislation provides some guidance on the interaction of section 163(n) with the section 163(j) limitation. A corporation that is subject to the proposed legislation would continue to be subject to the application of section 163(j), and a corporation that was subject to both section 163(j) and the new limitation would apply whichever of the two provisions imposed the lower limitation. Importantly, proposed new section 163(o) of the proposed legislation allows a carryover of the interest expense disallowed under section 163(j)(1) or section 163(n)(1). Under current section 163(j), carryforwards of disallowed interest expense are allowed to be carried forward indefinitely. However, the carryover period for disallowed interest under proposed section 163(o) would be limited to five tax years and carried over interest would be deducted on a first-in, first out basis.
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. A key consideration is whether a state requires or allows a single section 163(j) limitation (as is the case for federal income tax purposes) based on the computation at the federal consolidated group level. 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. It is unclear whether any differences would result in the application of proposed section 163(n) in the context of a federal consolidated group versus how it would apply on a separate company basis.

Furthermore, to the extent that a taxpayer could be subject to section 163(j) and section 163(n) and a state adopts both provisions, the provision under which the taxpayer’s interest deduction could be limited may be different 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 addback provisions adopted new section 163(n).

Approximately nine states have currently decoupled from section 163(j) by either making the provisions non-operational for state purposes or allowing a state specific deduction for the amount of interest disallowed at the federal level due to section 163(j). There may also be complications to the extent a state adopts proposed new section 163(n) but has decoupled from section 163(j). In this situation, for state purposes, a limitation could exist under section 163(n) although the federal limitation under section 163(j) does not apply or is added back. The five-year carryover period for interest limited under both section 163(j) and proposed section 163(n) could also create complications and tracking complexities at the state level.

**Closing thoughts**

If enacted, the proposed legislation would not have the dramatic effects that TCJA did on state income taxation. Nonetheless, corporate income taxpayers, especially multinationals, would likely experience increased complexity in complying with the proposed changes to GILTI and the new limitations on the deductibility of interest. A state not conforming to adopted federal changes would also present challenges. Accurate compliance with any federal changes would require close monitoring of state legislative and administrative activity, analyzing state and federal requirements carefully and dedicating the resources necessary to ensure information necessary for compliance is available.

**Impact of the proposals on accounting for income taxes**

The proposals included in the House Ways and Means Committee’s recommendations 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 in the interim period that includes the date of enactment.

As entities assess the impact of the proposals, there may be elements when 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 tax benefit 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 House Ways and Means Committee proposals but is not all inclusive.

**Corporate tax rate increase**

The proposals would replace the flat corporate income tax with a graduated rate structure consisting of an 18% rate on the first $400,000 of income, 21% on income up to $5 million, and 26.5% on income thereafter. Corporations with greater than $10 million of income would have benefit of the graduated rate system phased out. In accordance with section 15, fiscal year-end entities would utilize a blended rate for the tax year that straddles the effective date of January 1, 2022 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 were enacted, entities would 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 of the legislation. Upon enactment, if graduated rates are not expected to be a significant factor, a single flat tax rate may be used to measure deferred tax assets (liabilities). If the graduated tax rates are expected to be a significant factor, deferred tax assets (liabilities) should be measured using the average graduated tax rate expected to apply to temporary differences that are forecasted to reverse after the effective date.

Even though deferred taxes are not generally determined on a daily basis, reasonable effort should be made to estimate temporary differences at the enactment date as part of establishing the amount of adjustment to allocate to continuing operations.

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 would reverse once the proposed graduated rate structure 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 allocated to continuing operations and 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 of, liquidated or terminated and the release should be consistent with an entity’s existing policy on releasing such effects.

Global intangible low-tax income (GILTI)

The proposal includes fundamental changes to the GILTI regime. Among other changes to GILTI, the proposal would reduce the tax exemption from the first 10% return on foreign assets to the first 5%, would require 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), would repeal the taxable income limit to the section 250 deduction and would effectively increase the GILTI tax rate to 16.5625% by reducing the section 250 deduction with respect to GILTI to 37.5%. Additionally, the proposal would allow a carryover of country-specific net CFC tested losses.

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 Tax Cuts and Jobs Act. 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

It is not clear if the existing accounting policy election outlined in the staff Q&A would remain available if the modifications to the GILTI regime are finalized as proposed.

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.
Modifications to foreign tax credit limitations

The proposals include amendments to the foreign tax credit rules. Among other changes, the proposals would require a country-by-country determination of foreign tax credits, decrease the haircut on deemed paid credits for taxes attributable to GILTI from 20% to 5%, and repeal the foreign branch income basket.

The proposals further would modify the carryforward of excess foreign tax credits to five succeeding tax years with no carryback permitted (compared with a 10-year carryforward and one-year carryback currently allowed under existing law).

**KPMG observation**

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, including foreign tax credit carryforwards. Entities would need to evaluate the impact of the proposed changes to foreign tax credits to assess if sufficient taxable income of the appropriate character would be available to utilize foreign tax credit carryforwards in the reduced carryforward period. If sufficient positive evidence is not available to support the realization of the related deferred tax assets, a valuation allowance may be necessary to reduce the deferred tax assets to the amount that is more likely than not to be realized.

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.

Base erosion and anti-abuse tax (BEAT)

The proposed legislation would make several modifications to BEAT including amending the applicable rate to 10% in tax years beginning after December 31, 2021 and before January 1, 2024, 12.5% in tax years beginning after December 31, 2023 and before January 1, 2026, and 15% in tax years beginning after December 31, 2025.

Additionally, the proposals would adjust the determination of modified taxable income, provide for exceptions for certain payments as well as limits the applicability of the exception for taxpayers with a low base erosion percentage.

**KPMG observation**

Consistent with the FASB staff Q&A, companies should measure their deferred taxes based on the regular tax rate and account for the incremental tax owned under the BEAT system as it is incurred. Further, an entity does not need to evaluate the effect of potentially paying BEAT in future years when assessing the realizability of its deferred tax assets under the regular tax system; however, we believe an entity may elect to do so as an accounting policy election that should be consistently applied.

Interest expense of international financial reporting groups

The proposal would add an additional interest expense limitation when the interest expense deduction of certain domestic corporations which are members of an international financial reporting group would be limited to an allowable percentage of 110% of net interest expense. A domestic corporation’s allocable
share of the group’s net interest expense is the portion of such expense which bears the same ratio to the total group expense as the corporation’s earnings before interest, taxes, depreciation and amortization (EBITDA) bears to the group’s total EBITDA. This interest limitation applies only to domestic corporations whose average excess interest expense over interest includible over a three-year period exceeds $12,000,000.

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. Under the proposed legislation, the carryforward of disallowed interest expense would be limited to five years for tax years beginning after December 31, 2021.

**KPMG observation**

As of the date of enactment, an entity would 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 and expected EBITDA limitations, a valuation allowance is not appropriate even if the disallowed interest deductions are not expected to be used because the entity expects future interest incurred to exceed the amount that is deductible.

**Acceleration of modifications to the limitation on deduction of excess employee remuneration**

The proposal would accelerate the effective date for the amendments to section 162(m) included in the American Rescue Plan Act of 2021 (ARPA) from tax year beginning after December 31, 2026, to tax years following December 31, 2021. The ARPA expanded the definition of a covered employee under section 162(m) to include the five highest compensated employees in addition to those employees already treated as covered employees. However, this additional group of covered employees are not permanently considered covered employees.

**KPMG observation**

If enacted, the earlier effective date of the amendments to 162(m) may affect the measurement of deferred taxes for compensation related temporary differences. Companies should consider the disallowed compensation deduction and reduce the related deferred tax asset to reflect the amount of income tax benefit that it expects to realize in the future (in other words, the tax effect of the amount that is anticipated to be deductible in future periods) for covered employee compensation, taking into account the revised section 162(m) limitation.
Other considerations

Additional changes included within the proposal may impact an entity’s accounting for income taxes. The foreign derived intangible income (FDII) deduction modifications include, but are not limited to, removing the taxable income limitation and reducing the section 250 deduction to 21.875% resulting in an effective 20.7% rate in combination with the proposed 26.5% corporate rate. Further, the proposals defer the date from which research and experimental expenditures would need to be capitalized and amortized and amend section 245A (which currently permits a 100% participation exemption for foreign portions of dividends received from a specified 10% owned foreign corporation) to only apply to foreign portions of dividends received from controlled foreign corporations. Entities should evaluate any potential valuation allowance impacts of the changes to FDII and expense capitalization and the restrictions proposed under section 245A when measuring deferred taxes associated with such investments.

Additionally, new or expanded credits included in the final enacted legislation would need to be separately assessed to determine 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 legislative process moves forward with 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 Tax Cuts and Jobs Act 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 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 Tax Cuts and Jobs Act 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 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.
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