



“Build Back Better Act” tax proposals in House bill

KPMG analysis and observations

NOTE: Originally issued November 11, 2021.

Update on House passage added November 19, 2021.

November 11, 2021

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Important update on House passage

This report was initially issued on November 11, 2021, at which time a House vote on H.R. 5376, the “Build Back Better Act” (BBBA), was pending. On November 19, 2021, the U.S. House of Representatives passed H.R. 5376 by a vote of 220 to 213.

The tax proposals in H.R. 5376, as passed the House, are substantially the same as those that were pending in the House as of November 11, 2021; however, the bill that passed the House does not include language relating to grossing up certain amounts in the case of sequestration that was included in two places in the prior version of the bill.

Other than the addition of this Important Update and modification of the discussion of the proposed qualified environmental justice program credit (page 166) to reflect the elimination of “sequestration gross up” language, the content of this report is identical to what was issued on November 11, 2021.

This update was added on November 19, 2021.

- Read [text](#) [PDF 3.95 MB] (2,468 pages) of the bill as originally introduced in September 2021
- Read a [first manager’s amendment](#) [PDF 43 KB]
- Read a [second manager’s amendment](#) [PDF 34 KB]

Introduction

The U.S. House of Representatives has released new text of proposed tax legislation as part of the “Build Back Better Act” (BBBA) legislative effort. This pending legislation (the “House bill”) differs in important ways from previous proposals with respect to the BBBA.

The House has not yet voted on the House bill. In addition, further changes may be made as the House and Senate consider the legislation.

This report reflects developments as of noon EST on November 11, 2021. Stay tuned to KPMG’s [TaxNewsFlash-Legislative Updates](#) for developments after that date.

Recent events

On November 5, the House approved a Rule that provides for a vote on the BBBA, H.R. 5376. The vote on the bill itself has been postponed, pending estimates of spending and revenue by the Congressional Budget Office (CBO). However, a vote might take place the week of November 15. The bill is a somewhat slimmed down version of the “Build Back Better” economic plan proposed by the Biden Administration in April. If passed by the House, the bill would move to the Senate, where further changes would be expected. (For documents relating to the pending House bill, read [TaxNewsFlash](#).)

On November 5, the House also passed and sent to the president a \$1.2 trillion bipartisan infrastructure bill, the “Infrastructure Investment and Jobs Act.” Read [TaxNewsFlash](#)

Modifications to previous versions of the administration’s Build Back Better plan have been dictated in large part by the very narrow Democratic majorities in the House and Senate and by unanimous Republican opposition. With the approval of the administration, House Democrats have cut substantially the approximately \$4.5 trillion estimated cost of the House plan that was approved by the House Budget Committee in September and that included the Ways and Means Committee’s recommendations for tax (and other) measures. The House bill also is significantly smaller than the \$3.5 billion contemplated by the budget resolution that was approved in August and that set the stage for Democratic efforts to move the BBBA with only Democratic votes through the budget reconciliation process. The administration has indicated that the cost of the pending House bill is around \$2.1 trillion, based on its estimates of what it calls “gross investments.” The administration estimates the revenue raisers in the bill would raise \$2.15 trillion, such that the costs would be fully offset. Final estimates from the Congressional Budget Office, however, could well differ from those of the administration, requiring further modifications.

Modifications to previous Ways and Means Committee revenue proposals

The tax revenue provisions in the House bill differ in significant respects from the proposals approved by the Ways and Means Committee in September. Read [TaxNewsFlash](#). Most significantly, the pending House version of the BBBA does not include increases in rates—corporate, individual, or capital gains. Those changes were necessary to address concerns raised in the Senate.

For example, the House bill does not include the following proposals that Ways and Means had previously approved:

- A corporate income tax rate increase to 26.5%
- An increase in the top individual rate to 39.6%
- An increase in the top capital gains rate to 25%
- Modification of the rules for carried interests in partnership interests held in connection with performance of services
- A limitation on the section 199A deduction of qualified business income of high-income individuals
- Changes to rules applicable to grantor trusts
- Valuation rules for certain transfers of nonbusiness assets
- Increase in limits on estate tax valuation reduction for certain real property
- Accelerated termination of temporary increase in the unified credit
- Expansion of the rehabilitation tax credit
- Making new market tax credit (NMTC) permanent

The House bill also does not include several other proposals that have been raised by some Democrats, such as:

- A mark-to-market regime for very high-income individuals, trusts, and estates (the so-called “billionaires tax”)
- Reporting of account flows by financial institutions

The revenue from the proposed Ways and Means Committee tax changes was replaced by other proposals, including:

- A 15% minimum tax on adjusted financial statement income of corporations with three-year average income in excess of \$1 billion
- A 1% excise tax on the value of stock repurchased by publicly-traded U.S. corporations
- One-year delays in the effective date of many business and international proposals
- Modifications to tax rates for “global intangible low-taxed income” (GILTI) (15%) and “foreign-derived intangible income” (FDII) (15.8%).
- An increase the “base erosion and anti-abuse tax” (BEAT) rate (to 12.5% for 2023, 15% for 2024, and 18% for 2025 and thereafter)
- Surcharges on high income individuals, estate and trusts (5% of modified AGI in excess of \$10 million and an additional tax of 3% in excess of \$25 million)

The House also added to the Ways and Means proposals a substantial increase in the individual deduction for state and local taxes. The House bill would increase the deduction from \$10,000 to \$80,000 for the 2021-2030 period and reduce it \$10,000 for 2031, after which it would expire.

What’s next?

The House might vote on the BBBA by the end of the week of November 15, as anticipated by the passage of the Rule. If the House passes the bill, it will then move to the Senate, where further changes may be expected. Changes by the Senate would, of course, require further House action given that the House and Senate ultimately must approve the identical version of legislation before sending that legislation to the president.

As indicated above, House and Senate passage of the BBBA are complicated by the narrow Democratic majorities. The bill continues to face universal Republican opposition. Democrats currently have only an eight-seat majority in the 221-213 House, so they can afford to lose only three votes. The Senate is split 50-50, with the vice president providing the tie-breaking vote, so Senate Democrats cannot afford to lose a single Democratic vote.

Satisfying the oft-conflicting demands of almost every Congressional Democrat has slowed consideration of the bill and resulted in the great number of changes from the administration’s original plan. House Democrats attempted to satisfy many of the apparent demands of Senate Democrats, for example by eliminating changes to tax rates; however, other potential differences remain (both respect to tax and nontax components of the BBBA). Some Democrats in the Senate, for example, have stated opposition to the modification to the deduction for state and local taxes. Others would prefer alternative revenue-raising provisions to some of those in the House bill.

House consideration has been delayed until the week of November 15 to allow time for the CBO to produce authoritative estimates of revenue and spending. It is unclear whether those CBO estimates will confirm those of the administration and show that the revenue cost of the bill is fully offset. Previous estimates by the CBO of revenue gained by increased funding by the IRS, for example, have been significantly less than the administration’s estimate. Shortfalls in revenue, or increases in estimates for BBBA spending proposals, could require modifications of BBBA provisions or, potentially, the addition or modification of revenue measures. Such changes could come from among those previously approved by the Ways and Means Committee, from the administration’s Green Book proposals (read [KPMG’s report](#) [PDF 1.4 MB]), or elsewhere. As Sen. Ben Cardin (D-MD) said recently of the bill, “This is a work in progress.”

This report describes the revenue proposals of the House bill and provides analysis and observations.

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Corporate provisions

Corporate alternative minimum tax

The House bill would introduce a new 15% corporate alternative minimum tax (Corporate AMT) on the “adjusted financial statement income” of certain large corporations (very generally, and described in greater detail below, corporations reporting at least \$1 billion average adjusted pre-tax net income on their consolidated financial statements), for tax years beginning after December 31, 2022.

The JCT has estimated that this proposal would raise approximately \$318.9 billion over the 10-year budget window.

KPMG observation

Under the proposal, taxpayers could owe Corporate AMT whenever they have significant permanent or temporary book-tax differences that cause book income to exceed taxable income in a given year. These differences could arise from, among other things:

- Excess tax benefits with respect to share-based payments, including stock options;
- Accelerated tax depreciation and depletion;
- Accrued liabilities, including pensions; and
- Acquired deductible temporary differences and NOLs, notwithstanding regulatory authority to address corporate reorganizations.

Although timing differences generally would reverse so that the indefinite Corporate AMT credit carryforward could help to ameliorate their impact over time, there are a number of circumstances where this may not be the case, including, for example, when, due to the ordering of when an item is recognized for book and tax purposes, the existence of an AMT credit carryforward is less useful than would be the case for an AMT credit carryback. This would be the case, for example, when a taxpayer recognizes an expense for a significant nonrecurring item, such as a new lawsuit or industrial accident, for book purposes for a liability that becomes deductible in a subsequent year. Another reason that timing differences may be converted to permanent differences is due to the lack of transition rules included in the Corporate AMT to account, for example, for deferred tax assets that exist on transition for expenses that have been recognized prior to the effective date for book purposes but that are not yet deductible for tax purposes. An extreme version of this latter issue exists for pre-2020 NOLs, for which the proposal includes no transition relief.

Finally, while Foreign-Derived Intangible Income (FDII), at least after the House bill’s proposed increase in the effective rate of tax to 15.792%, by itself, would not cause a taxpayer to owe corporate AMT, the FDII deduction could help to bring a taxpayer closer to the 15% rate such that,

in combination with other items discussed above, a taxpayer could find itself owing Corporate AMT.

KPMG observation

The TCJA repealed the prior corporate alternative minimum tax (Former AMT) for tax years beginning after December 31, 2017. The new Corporate AMT tax base calculation would use financial statement income as its starting point—a major distinction from the Former AMT. However, in other ways, the Corporate AMT would operate similarly to the Former AMT. For example, like the Former AMT, the Corporate AMT would be based on the excess of “tentative minimum tax” over regular tax, and payment of the Corporate AMT would give rise to a tax credit that could be used against regular tax in excess of tentative minimum tax in future years. Thus, as with the Former AMT, at least conceptually the Corporate AMT can be thought of as requiring certain taxpayers to prepay their regular tax but not as increasing cumulative federal income tax liability. The [accounting for income taxes section](#) has further details regarding the potential impact of the House bill, including the Corporate AMT, on income tax accounting.

The House bill would provide significant regulatory authority with respect to most aspects of the Corporate AMT. Thus, in many respects the operation of the Corporate AMT would depend on Treasury’s decisions in implementing the regime.

The Corporate AMT was not included in the prior Ways and Means proposal. The Green Book proposed, albeit with significantly less detail, a conceptually similar corporate minimum tax. The Green Book stated that, in a typical year, around 120 companies issue financial statements that report pre-tax net income of \$2 billion or more (double the \$1 billion average adjusted book profits threshold in this proposal), and that a “significant share” of these firms pay zero income tax or receive tax refunds. The one-pager that accompanied a version of a corporate minimum tax that came from Chairman Wyden, and Senators Warren and King, and is similar to the House bill, indicated that roughly 200 companies report \$1 billion of book profits. Commentators, including Martin Sullivan, have estimated that the number of companies in scope would be smaller.

A U.S. income tax based on the book income of corporations is not a new idea, and similar proposals have been made from time to time. A version of such a tax was in place from 1987-1989, as a positive AMT preference item in the Former AMT regime. The 1986 Tax Reform Act had imposed a requirement that the AMT income for corporate taxpayers be adjusted by certain “book income adjustments.” In particular, AMT income for corporate taxpayers generally was increased by 50% of the amount by which the corporation’s adjusted net book income exceeded its AMT income for the tax year. A compromise in the 1986 conference agreement made the adjustment applicable only to tax years beginning in 1987, 1988, and 1989, and supplanted it with the “adjusted current earnings” (or “ACE”) adjustment for tax years beginning after 1989.

Taxpayers potentially subject to the Corporate AMT

Applicable corporation—in general

The Corporate AMT would apply to an “applicable corporation”—any corporation, other than an S corporation, regulated investment company, or real estate investment trust, which meets the “average annual adjusted financial statement income test” (Income Test) in one or more tax years ending after December 31, 2021, but prior to the tax year at issue (e.g., if a corporation first met the Income Test in

its 2022 tax year, it would be an applicable corporation beginning in its 2023 tax year).

KPMG observation

The “applicable corporation” definition in proposed section 59(k) does not, by its terms, limit the scope of such term only to companies that owe U.S. tax (i.e., domestic corporations and foreign corporations with U.S. ECI) that meet the average annual \$1 billion threshold earnings requirements described below. However, the mechanics of the proposed Corporate AMT seem to achieve this result. Specifically, as described below, an applicable corporation’s tentative minimum tax would be limited to the excess of (1) 15% of the applicable corporation’s adjusted financial statement income (AFSI) (as determined under proposed section 56(A) for the tax year, over (2) the Corporate AMT foreign tax credit for the tax year. As discussed in greater detail below, a foreign corporation’s AFSI only includes its adjusted book profits that relate to U.S. ECI. As such, a foreign corporation without U.S. ECI would not appear to be subject to the Corporate AMT proposal.

In general, the Income Test would be met for a tax year if the average annual AFSI of a corporation in the three tax years ending with the tax year at issue exceeds \$1 billion (subject to certain adjustments for newly formed corporations, predecessor corporations, and short tax years).

Solely for purposes of the Income Test, aggregation rules would apply to determine a corporation’s three-year average AFSI. Under the aggregation rules, all persons treated as a single employer under section 52(a) and (b) are treated as one person. In general, section 52(a) provides for aggregation of a controlled group of corporations meeting a more than 50% common ownership standard under section 1563(a). Section 52(b) provides a similar rule for non-corporate organizations (partnerships, trusts, estates, and sole proprietorships) of trades or businesses. Generally, this aggregation rule would apply (with some exceptions for U.S.-parented groups with less-than-wholly-owned foreign affiliates) to count all of the adjusted book profits of the domestic *and foreign* entities in the international financial reporting group (IFRG) towards the \$1 billion AFSI threshold test. The House bill would also make certain amendments to section 52(a) and (b), [as discussed later in this report](#).

If the corporation is a member of a foreign-parented IFRG, the \$1 billion AFSI threshold requirement (subject to certain very subtle and often immaterial modifications) would be supplemented by a special \$100 million AFSI test that would only take into account the group’s U.S.-related AFSI (i.e., U.S. ECI-related adjusted book profits of foreign corporations and AFSI of domestic corporations, including CFC income) (together, the “foreign-parented IFRG” rule). The additional \$100 million test for U.S.-related AFSI would apply based on the same average three-year period rule as applies to the \$1 billion test.

An IFRG is defined by cross-reference to the definition in the House bill’s proposed U.S. interest expense limitation rule under proposed section 163(n)(3), which provides that an IFRG means two or more entities included in the same “applicable financial statement” (described below) with respect to the same tax year if either (1) at least one entity is a foreign corporation with U.S. ECI or (2) one entity is a domestic entity and another entity is foreign.

KPMG observation

Generally, the foreign-parented IFRG rule would preclude the Corporate AMT proposal from applying to certain foreign-parented groups that have substantial aggregate adjusted book income

but relatively small (i.e., less than \$100 million) U.S.-related adjusted book income.

For example, assume that Foreign Parent (FP) is a corporation that wholly-owns two corporate subsidiaries—U.S. Sub (USS) and Foreign Sub (FS)—all members of the same IFRG. Further assume that the combined average annual adjusted book profits of FP and FS are equal to \$1 billion and USS’s average annual AFSI (including CFC income) is \$50 million for the applicable testing period. If none of the average annual adjusted book profits of FP and FS relate to U.S. ECI, then USS would not be considered an applicable corporation under the foreign-parented IFRG rule. While the foreign-parented multinational group would satisfy the more than \$1 billion average annual AFSI requirement, only USS’s \$50 million AFSI would count for purposes of applying the special \$100 million U.S.-related AFSI requirement.

Once a corporation satisfies the Income Test in any tax year ending after December 31, 2021, the corporation generally would continue to be an applicable corporation even if its income subsequently declines. The bill does provide that a corporation that previously met the requirements under the Income Test would no longer be considered an applicable corporation if (1) either (a) there is a change in ownership with respect to such corporation, or (b) there is a consistent reduction in AFSI below the relevant threshold; and (2) the Secretary determines it would not be appropriate to continue to treat the corporation as an applicable corporation.

KPMG observation

The exception to applicable corporation status for a corporation that has previously met the Income Test appears to require some form of affirmative guidance from Treasury; it is unclear whether the guidance would be categorical (such as a revenue procedure) or individualized (such as a determination letter or private ruling letter). The House bill does not, however, indicate what factors should be considered in determining whether it is appropriate to continue to treat a corporation as an applicable corporation.

The bill does not define the term “change in ownership” for this purpose. Existing section 382 provides a complex regime to determine when a corporation experiences an “ownership change,” but the bill does not cross-reference section 382.

The Income Test and AFSI

The Income Test would be based on the corporation’s AFSI for each tax year in the testing period. A corporation’s AFSI calculation would generally start with the net income or loss reported on its “applicable financial statement” (AFS). A corporation’s AFS would be defined (subject to modification by Treasury) by reference to section 451(b)(3) and would generally include GAAP, IFRS, or other financial statements used for reporting to a governmental agency such as the SEC or a foreign equivalent. Further, if a corporation’s financial results are reported on an AFS for a group of entities, such statement would be considered the corporation’s AFS.

KPMG observation

The term “net income” for financial reporting purposes likely refers to the “net income” line on the financial statement and not total comprehensive income, which would also include certain categories of income (e.g., certain hedging and pension plan income) that are not included in that

line.

As described in more detail below, AFSI would not simply be the aggregate net income reported on the consolidated financial statements. Rather, the adjustments that would be involved in calculating AFSI could require separate calculations not normally undertaken in calculating consolidated financial results.

KPMG observation

In the context of assessing “applicable corporation” status, the proposal shares similarities to certain rules that apply when determining base erosion and anti-abuse tax (BEAT) “applicable taxpayer” status. Like the BEAT, the House bill’s Corporate AMT proposal would use a 3-year taxable period when applying the income threshold tests. The drafting of the 3-year taxable period rule in the proposal is less clear than in the BEAT, but it seems that both rules operate to treat a corporation as an in-scope entity if the relevant gross receipts (in BEAT) or income thresholds (in the Corporate AMT proposal) are met based on an annual average of those items during the three preceding tax years.

Also, similar to the BEAT gross receipts threshold test, the House bill contains an entity aggregation rule for determining applicable corporation status that applies section 1563 group ownership rules as modified by section 52. In the BEAT context, the aggregation rule treats all domestic and foreign corporations connected through a greater-than-50% common control as one person. The BEAT aggregation rule achieves this outcome by applying section 1563 group ownership rules as modified by subsections 52(a) and (b), but expands section 1563 group ownership to include foreign corporations without U.S. ECI by disregarding the non-ECI foreign corporation exception in section 1563(b)(2)(C). Although the Corporate AMT aggregation rule does not reference the section 1563(b)(2)(C) non-ECI foreign corporation exception, the rule is expected to apply in the same manner as in the BEAT because proposed section 138151 (Rules Relating to Common Control) of the House bill would amend section 52 directly to disregard all exclusions under section 1563(b)(2).

While BEAT’s entity aggregation rule does not distinguish foreign corporations with U.S. ECI from foreign corporations without U.S. ECI when identifying a taxpayer’s aggregate group, the BEAT gross receipts threshold test only includes gross receipts of a foreign corporation to the extent taken into account in determining its U.S. ECI. In contrast, the proposed Corporate AMT general Income Test appears to also include the taxpayer’s pro rata share of *all* CFC income.

Adjustments to financial statement income

The following additional rules would apply in determining the extent to which a corporation’s AFSI would include income from entities related to or affiliated with that corporation (subject to adjustments for omissions or duplications in guidance to be provided by Treasury):

- If a corporation reports its taxable income as part of a consolidated group, items that are properly allocable to other members would be considered part of the corporation's AFSI.

KPMG observation

This provision appears intended to treat all members of a consolidated group as a “single entity” for purposes of the Corporate AMT. This, however, raises a number of issues, including how the statutory provision would apply when a subsidiary leaves a consolidated group. For example, the provision would require that, for purposes of computing a taxpayer’s AFSI, the taxpayer take into account items on the taxpayer’s AFS which are properly allocable to members of the same consolidated group. Under this rule, a subsidiary could potentially be an applicable corporation as a result of the consolidated group’s income and it could retain “applicable corporation” status even after it departs from the consolidated group and would not meet the Income Test separately. However, the provision would grant Treasury the authority to provide exceptions to “single entity” treatment. Similar issues arose under the BEAT rules and were the subject of a number of different proposed (often controversial) approaches before final regulations were adopted.

- If the financial results of a taxpayer are reported on the AFS for a “group of entities,” the proposal would apply “rules similar to the rules of section 451(b)(5).”
- If a corporation reports its financial results in an AFS that includes one or more partnerships, the corporation’s distributive share of the profits and losses in such partnership(s) would be taken into account when determining the corporation’s AFSI.
- The earnings and profits of an another corporation (including a minority interest in a corporation) that is not included on a consolidated return with the corporation would be included in the corporation’s AFSI only to the extent of dividends (excluding distributions of previously taxed earnings and profits of CFCs) and certain other amounts included under Chapter One.

KPMG observation

The proposal generally provides that a taxpayer’s AFSI would be adjusted as necessary to disregard the undistributed earnings of corporations that are not in the taxpayer’s consolidated return. For certain investments, such as those between 20-50% ownership, the holder might report its share of the lower-tier entity’s net income under the equity method for financial reporting purposes. It seems clear that the proposed rule would generally reverse out this equity method accounting treatment when determining a taxpayer’s AFSI. However, there is ambiguity regarding the application of this rule in situations where a long-term, strategic investment, such as an investment with less than 20% ownership in corporate stock, may be accounted for using the fair value accounting method. If a holder reports the lower-tier investment under the fair value method for financial reporting purposes, the holder would use a mark-to-market method to report the change in value of the lower-tier corporation. This generally would not match, or even necessarily correspond with, the lower-tier corporation’s earnings during such period. Because the fair value method is not tied to the earnings of the lower tier corporation, it seems that this proposed rule would not, by its terms, apply to disregard the fair value method when determining a taxpayer’s AFSI. There is no evident policy justification for the disparate treatment of taxpayers that apply the equity method versus the fair value method as to strategic investments (recognizing that a dealer’s inventory of securities would raise different issues). Further, were this rule to apply in the case of a minority U.S. shareholder in a CFC it would, without co-ordination, result in both the inclusion of a pro rata share of the CFC’s AFSI and a mark-to-market gain or loss with respect to the CFC shares.

- If a corporation is a U.S. Shareholder of one or more CFCs, the AFSI of such corporation would be adjusted to take into account the corporation's pro rata share (determined under section 951(a)(2) principles) of the net income or loss as computed on the AFS for each CFC. The pro rata share would include all CFC income without regard to whether such income is subpart F, GILTI, or section 245A exempt. The corporation's pro rata share of net income and loss from each CFC is netted for purposes of the Corporate AMT calculation and not computed on a country-by-country basis. However, to the extent that a corporation's pro rata share of net income and loss from CFCs would result in a negative adjustment to the corporation's AFSI, such negative adjustment would be disallowed and carried forward (and applied) to the corporation's next tax year.

KPMG observation

This item appears to conflict with the provision that would limit the inclusion of a CFC's earnings in the AFSI of its U.S. Shareholder to the amount paid in dividends. This appears to be a drafting glitch; the AFSI rules appear intended to include income earned indirectly through a CFC, regardless of whether distributed in the form of a dividend.

KPMG observation

The proposal to allow a taxpayer to use CFC losses in one jurisdiction to offset CFC income in a separate jurisdiction in the same tax year is similar to the operation of existing section 951A, in contrast to the House bill's proposal to amend the GILTI regime by adopting a country-by-country approach. Unlike the existing GILTI regime, however, the House bill's Corporate AMT proposal would establish CFC NOLs that may be used in future years to reduce the taxpayer's pro rata share of future year CFC net income.

Also, unlike the regular U.S. tax system, the taxpayer's AFSI would be adjusted by its pro rata share of CFC income without regard to whether such income is otherwise includible under section 951 or section 951A.

- A corporation would be required to adjust its AFSI to take into account any AFSI of a disregarded entity (DRE) owned by the corporation that is not otherwise included in the corporation's AFS.

KPMG observation

This rule seems intended to ensure that all of the AFSI of foreign hybrid entities and other DREs is treated as AFSI of the entities' owners. However, this appears to be surplusage given the reference to section 451(b)(5) for purposes of determining how to treat financial results of a taxpayer that are reported on a consolidated financial statement for a "group of entities," as noted above. Because section 451(b)(5) and the regulations thereunder start with the single consolidated financial statement and find items attributable to the "taxpayer" (a U.S. tax concept which includes a DRE as part of its owner, as opposed to the concept an "entity" which can exist without regard to U.S. check-the-box fictions) it is never going to be necessary to look to the separate financial statement of a DRE.

Additional adjustments to AFS include (but are not limited to):

- Adjustments to account for AFS that cover periods different than the corporation's tax year;
- Adjustments to increase a corporation's AFSI for foreign income taxes taken into account on the corporation's AFS, to the extent the corporation elects to claim foreign tax credits;
- In the case of a foreign corporation, the principles of section 882 generally apply to include only ECI in the determination of AFSI;
- Adjustments to prevent the omission or duplication of items;
- Adjustments to take into account minority ownership of members of a consolidated group; and
- Adjustments to carry out the principles of the corporate liquidation, organization, and reorganization rules, and the rules relating to partnership contributions and distributions.

KPMG observation

The explicit reference to the application of section 882 principles seems to confirm that a foreign corporation's AFSI would be limited to the items of book income or loss that relate to U.S. ECI. As such, foreign corporations without U.S. ECI would not have AFSI. It is unclear how section 882 principles would be applied in the financial accounting context to parallel the application of the U.S. ECI rules for U.S. taxable income purposes, and it could potentially require extensive additional work to reconstruct financial accounts in accordance with a principle that has heretofore only applied in the U.S. tax accounting realm.

Financial statement net operating losses

The House bill would include a reduction to AFSI for "financial statement net operating losses" (FS NOLs). Specifically, AFSI would be reduced by the lesser of (a) the aggregate amount of the corporation's FS NOL carryovers, and (b) 80% of the AFSI computed without regard to FS NOL carryovers. FS NOL carryovers would arise from AFSI net losses for tax years ending after December 31, 2019. An FS NOL could be carried over indefinitely.

KPMG observation

A corporation can generate FS NOLs in tax years prior to the first tax year in which the Corporate AMT could apply. For example, if a calendar year corporate taxpayer has AFSI of \$1 billion in both 2020 and 2021, but a loss of \$750 million in 2022, the taxpayer would have an FS NOL carryover from 2022 available to reduce AFSI in subsequent years. Conversely, if that calendar year taxpayer had the loss of \$750 million in 2020, and then AFSI income of \$1 billion in both 2021 and 2022, it appears that the 2020 loss may be absorbed in 2021 prior to the first tax year, 2023, in which the Corporate AMT could apply.

Further, a corporation may become an applicable corporation after the effective date of the Corporate AMT regime, due to revenue growth or acquisitions. It appears that such a corporation could generate FS NOLs in tax years prior to becoming subject to the Corporate AMT, and that these FS NOLs would be reduced by AFSI in later periods. Thus, seemingly, a corporation that becomes subject to the Corporate AMT at any point would need to calculate its FS NOLs (and any offset of those NOLs against financial statement income) for all tax years ending after December 31, 2019.

For regular tax purposes, the use of net operating losses can become subject to limitation following an “ownership change” within the meaning of section 382, and net operating losses may be reduced as a result of the exclusion of cancellation of indebtedness income from gross income under section 108. Similarly, the use of net operating losses imported into a consolidated group can become subject to the separate return limitation year (SRLY) limitation. The House bill does not provide for any similar rules or coordinating adjustments to these regular tax provisions (although it does provide broad regulatory authority to Treasury to potentially address these points).

Further, for regular tax purposes, a member of a consolidated group that contributes to a consolidated net operating loss can have a portion of that loss allocated to it when it leaves the group (such as when the member is sold to an unrelated buyer). The House bill would grant authority for regulations as necessary to carry out the purposes of the AFSI rules, which presumably would include regulations that address many of the issues raised by FS NOL carryovers.

The House bill would also provide Treasury with broad authority to promulgate regulations to provide other adjustments to AFSI that are necessary to carry out the purposes of the Corporate AMT.

Calculation of Corporate AMT liability

The bill provides that an applicable corporation would be liable for the Corporate AMT to the extent its “tentative minimum tax” exceeds its regular U.S. federal income tax liability (including the BEAT under section 59A), prior to taking into consideration general business credits under section 38. An applicable corporation's tentative minimum tax would equal 15% of the applicable corporation's current year AFSI over the applicable corporation's eligible Corporate AMT foreign tax credits.

Corporate AMT foreign tax credit

If the taxpayer chooses to claim a foreign tax credit (FTC) under section 901 for the year, the Corporate AMT FTC for the year would be the sum of two amounts:

- The lesser of (1) the corporation’s pro-rata share of section 901 creditable foreign taxes paid or accrued (for federal income tax purposes) by its CFCs that are taken into account on the AFS of the CFCs, or (2) 15% of the CFCs’ net income for the year as reported on the CFCs’ AFS; AND
- (3) the total amount of section 901 creditable foreign taxes paid or accrued (for federal income tax purposes) by the taxpayer and taken into account on the taxpayer’s AFS.

KPMG observation

Although the Corporate AMT FTC would use section 901 creditable taxes to determine the base amount of foreign taxes paid, it is noteworthy that the proposal does not cross-reference the section 904 foreign tax credit limitation rules at all. As such, the Corporate AMT FTC, unlike section 901 FTCs, would not appear to be limited to U.S. tax on the relevant foreign source income nor would there be any limit on cross-crediting among low-tax and high-tax jurisdictions.

KPMG observation

The proposal's restriction on CFC taxes to 15% of CFC income for purposes of determining the amount of the Corporate AMT FTC is in stark contrast to the treatment of foreign taxes paid by the applicable corporation directly or with respect to a DRE, which are subject to no limit. The policy rationale for treating taxes paid by a CFC differently to taxes paid by a taxpayer on behalf of a DRE is unclear. Nonetheless, it appears generally that applicable corporations with high-tax CFCs might be in a worse position under the proposal, as compared with those that organize their high-tax foreign operations through DREs, which may encourage taxpayers to check the box on their CFCs to treat them as DREs.

KPMG observation

As discussed above, under the proposal, the AFSI of an applicable corporation includes the AFSI of a DRE owned by the applicable corporation and this appears to be the case under the basic rules of new section 56A(c)(2)(A) and section 451(b)(5) even before application of the special rule for DREs contained in new section 56A(c)(6), which appears to be surplusage. Thus, FTCs of the DRE could be available even if the DRE is treated as a separate entity from the corporation in preparing the AFS. Clarification of this point might, nevertheless, be helpful.

KPMG observation

There is ambiguity concerning which year taxes are taken into account in the Corporate AMT computation when the year of tax accrual for financial accounting purposes does not match the year such taxes are paid or accrued for regular tax purposes. While not clear, when such timing mismatch occurs it seems that the taxes would be taken into account in the later year because the rule appears to require that the taxes (1) be taken into account on the financials AND (2) to have been paid or accrued for U.S. tax purposes.

To the extent the credit for taxes paid by CFCs in the year is reduced because of the 15% limitation, the excess foreign taxes are allowed as a carryover in any of the first five succeeding tax years.

General business credits

The House bill would make amendments to section 38 (General Business Credit (GBC)) to take into account the Corporate AMT as well as BEAT. The House bill would limit the availability of general business credits to \$25,000 plus 75% of a taxpayer's net income tax that exceeds \$25,000. This generally follows the current pre-House bill paradigm for the ability to use GBCs. For this purpose, net income tax means the sum of (1) regular tax liability, (2) AMT and (3) BEAT, reduced by credits allowed under Subpart A and B of Part IV of the Code (Credits Against Tax). Section 901 foreign tax credits are included among the taxes described under Subpart B.

KPMG observation

As in computing net income tax, both the AMT FTC (which is part of the AMT calculation) and section 901 credits that reduce regular tax liability would be taken into consideration. The fact that GBCs can potentially be used to satisfy a new corporate minimum tax is very significant because

with the Former AMT:

- GBCs were generally not available to offset any corporate AMT; and
- If a taxpayer had no AMT liability, the taxpayer generally could not use GBCs to reduce its tax liability below its tentative minimum tax. For example, if a corporate taxpayer had a regular tax liability of \$10,000,000 and a tentative minimum tax of \$8,000,000, the taxpayer would not have any AMT liability, but generally would not be allowed to claim GBCs in an amount that would reduce its tax liability below the tentative minimum tax threshold of \$8,000,000.

KPMG observation

It is perhaps noteworthy that there is no special treatment under this proposal for the section 250 deduction for FDII (generally applicable to sales or services provided to foreign persons and/or outside the United States). Thus, in contrast, to the treatment of GBCs where favorable treatment is generally preserved under the Corporate AMT, a taxpayer that would otherwise benefit from section 250 may lose significant benefits under the proposal.

Corporate AMT credit

Applicable corporations would also be allowed to claim a credit for Corporate AMT paid against regular tax in future years, but the credit could not reduce that future year's tax liability below the computed Corporate AMT for that year.

KPMG observation

As noted previously, the proposed Corporate AMT credit mechanism is similar to the AMT credit provided by the Former AMT regime and would similarly cause the proposed Corporate AMT to be (at least theoretically) seen as an acceleration of regular tax liability.

Under the Former AMT, a taxpayer's ability to use minimum tax credit carryovers could become limited under the rules of section 383, following a section 382 ownership change. The House bill would place the proposed Corporate AMT credit within the framework of section 53, which sets forth the rules that applied to the Former AMT (and that continue to apply to certain noncorporate taxpayers after the repeal of the Former AMT). Thus, Corporate AMT credit carryovers would be expected to be subject to a section 383 limitation following an ownership change.

Miscellaneous

KPMG observation

The Corporate AMT proposal might be viewed as part of an effort by lawmakers to insulate *domestic* entities from tax under another country's Undertaxed Payment Rule (UTPR), which could apply to U.S.-parented multinational groups with €750 million or more of gross revenue in respect of cross-border payments from UTPR-implementing jurisdictions to U.S. entities in the same group. As currently contemplated at the OECD, avoiding the application of a UTPR to domestic entities would require establishing that the average ETR (as measured based on the Pillar Two rules) with respect to the domestic entities in a group (excluding DREs and branches that are tax resident or

have a taxable presence in another country) is at least 15%.

The Corporate AMT proposal would share some similarities to the anticipated Pillar Two ETR framework (which remains under development), in that both would use financial accounting income as the starting point for the denominator of the ETR calculation and apply 15% as the minimum rate of tax. Notwithstanding these similarities, there is no indication that all or even most of the adjustments to financial statement income proposed in the Corporate AMT will be picked up at the OECD for Pillar Two, and vice versa. Additionally, as proposed, the Corporate AMT would allow general business credits to reduce the Corporate AMT liability, whereas it is anticipated that the Pillar Two rules would not allow similar credits.

These potential differences could leave a U.S. Corporate AMT taxpayer with an ETR that is lower than 15% for OECD Pillar Two purposes.

Excise tax on stock repurchases

The House bill would impose a new 1% excise tax on repurchases of stock by certain publicly-traded corporations. Specifically, the excise tax would apply to repurchases of stock by domestic corporations with stock traded on an established securities market (“Covered Corporations”).

KPMG observation

“Repurchase” is defined as a redemption within the meaning of section 317(b), which generally includes any acquisition by a corporation of its stock from a shareholder in exchange for property, except for its stock or rights to acquire its stock. Thus, the excise tax would extend to typical stock buy-back programs implemented through traditional open market transactions and through privately negotiated purchases.

The excise tax, however, also would appear to extend to transactions that are treated as constructive redemptions for federal income tax purposes, such as leveraged buyouts of a publicly traded target corporation. In a typical leveraged buyout, an acquirer (A) forms a new wholly owned subsidiary (M) to “reverse merge” into a target corporation (T) with T surviving. Prior to the merger, A provides some equity funds to M, and causes M to borrow additional funds to facilitate the purchase of the T stock. In the merger, the T stock is converted into a right to receive the cash, the M stock is converted into stock of the surviving entity (which becomes wholly owned by A), and T inherits liability for the debt incurred by M. For federal tax purposes, the formation and merger of M is disregarded as transitory, and T is intended to be treated as incurring the debt and transferring the borrowed funds to its shareholders in a distribution in redemption of its stock. The excise tax would appear to apply to such a constructive distribution in redemption of stock of a Covered Entity. Furthermore, the House bill does not contain any exception when a corporation acquires its stock in exchange for property in a distribution in complete liquidation.

The excise tax would also apply to repurchases by foreign corporations with stock traded on an established securities market that become surrogate foreign corporations after September 20, 2021 (“Specified SFCs”). A surrogate foreign corporation is defined by reference to the inversion rules of section 7874, which very generally refers to a foreign corporation that directly or indirectly acquires substantially all the assets of a domestic corporation or partnership (an “expatriated entity”), if the former shareholders or partners (as applicable) own at least 60% of the stock of such foreign corporation and its expanded affiliated group does not have substantial business activities in its jurisdiction (compared to

total business activities of the group).

The House bill would also authorize the IRS to determine that economically similar transactions constitute repurchases. (We refer to repurchases of stock of Covered Corporations and Covered SFCs, and economically similar transactions, as “Covered Repurchases”.)

KPMG observation

The term “established securities market” is broadly defined to include: (1) a national securities exchange registered under section 6 of the Securities Exchange Act of 1934; (2) a national securities exchange exempt from registration under such act because of the limited volume of transactions; (3) a foreign securities exchange that, under the law of the jurisdiction where it is organized, satisfies regulatory requirements analogous to those of such act; (4) a regional or local exchange; and (5) an interdealer quotation system that regularly disseminates firm buy or sell quotations by identified brokers or dealers by electronic means or otherwise.

In addition to Covered Repurchases, the excise tax would apply to purchases by “Specified Affiliates” (treated as Covered Repurchases) of stock of Covered Corporations, Covered SFCs, and foreign corporations with stock traded on an established securities market (the latter of such corporations, “Applicable FCs,” and all such corporations, “Covered Entities”), from a person other than the applicable Covered Entity or its Specified Affiliates. A Specified Affiliate would include any corporation or partnership more than 50% of the stock (by vote or value) or interests (capital or profits), respectively, of which is owned (directly or indirectly) by a Covered Entity. However, in the case of an Applicable FC (other than a Covered SFC), the excise tax would only apply to purchases by its domestic Specified Affiliates (directly, or through a foreign partnership) (all purchases of stock treated as Covered Repurchases, “Covered Purchases,” and, together with Covered Repurchases, “Covered Transactions”).

The excise tax would be imposed on the value of the stock repurchased (or treated as repurchased). In the case of a Covered Corporation, the amount on which the tax is imposed would be reduced by the value of any stock issued by such corporation during the tax year (including stock issued to employees of the Covered Corporation or Specified Affiliate, whether or not issued pursuant to the exercise of options). By contrast, in the case of a Covered SFC or an Applicable FC, such amount would only be reduced by the value of any stock issued by the applicable Covered Entity to its employees during the tax year. The House bill would also create six exceptions to which the tax would not apply, including: (1) to the extent a repurchase is part of a reorganization under section 368(a) and no gain or loss is recognized by the shareholder; (2) if the stock repurchased or an amount of stock equal to the value of such stock is contributed to an employer-sponsored retirement plan, an employee stock ownership plan, or similar plan; (3) if the total value of the stock repurchased during the tax year does not exceed \$1 million; (4) repurchases by dealers of securities in the ordinary course of business under regulations; (5) repurchases by regulated investment companies (“RICs”) or real estate investment trusts (“REITs”); and (6) repurchases treated as dividends.

The House bill would grant authority for regulations to prevent abuse, address special classes of stock and preferred stock, and apply the excise tax to Covered SFCs and Applicable FCs. The excise tax would be non-deductible. The tax would apply to Covered Transactions occurring after December 31, 2021.

KPMG observation

The excise tax would apply to repurchases of “any stock” of a Covered Corporation or a Covered

SFC (and purchases of “stock” of a Covered Entity by a Specified Affiliate from a person other than the applicable Covered Entity or its Specified Affiliates), regardless of whether the particular stock that is repurchased is of a class that is traded on an established securities market. While the House bill would grant regulatory authority to address special classes of stock and preferred stock, until regulations are promulgated to exclude a particular class of stock, the excise tax would be applicable to Covered Transactions with respect to all stock of Covered Entities regardless of its trading status.

The proposal is projected by the JCT to generate revenue of approximately \$124.2 billion over the 10-year budget window.

KPMG observation

The excise tax would be imposed on the “fair market value” of the stock repurchased (or treated as repurchased). Presumably, such value is to be determined on the date of the applicable Covered Transaction and by the amount paid to repurchase the stock; however, the House bill does not expressly state when such value is to be determined. This could lead to uncertainty. For example, consider the exception for contributions of an amount of stock equal to the value of the stock repurchased to employer-sponsored retirement plans, employee stock ownership plans, and similar plans. A contribution may not occur on the same date as the applicable Covered Transaction. For such a contribution, would the value be based on a particular trading price on a particular date (or time of day), an average trading price on a particular date, or a metric such as the average trading price over, say, a trailing three trading day period? The relevant amount could vary, particularly with respect to stock that is thinly traded or that has a volatile price.

In addition, the House bill does not provide any exception to the imposition of the tax on the value of the stock repurchased for circumstances in which the amount paid in a Covered Transaction is not equal to such value. For example, stock issued to an employee and with respect to which an election is made under section 83(b) may be subject to forfeiture at a price other than fair market value. Regulations could be written to create special rules for this and similar situations. However, unless and until such regulations are promulgated, the excise tax would apply to the fair market value of the stock repurchased, irrespective of the actual price paid.

Furthermore, the excise tax would not apply to a repurchase “to the extent” that it is part of a reorganization within the meaning of section 368(a) and no gain or loss is recognized by the shareholder by reason of the reorganization. In such a reorganization, under section 354(a)(1), a shareholder does not recognize any gain or loss upon the exchange of stock of a corporation a party to the reorganization solely for stock of such a corporation. However, if the shareholder receives money or other property (commonly referred to as “boot”) in the exchange, the shareholder recognizes gain (but not loss) in an amount not exceeding the value of the boot. Thus, in the case of a reorganization with boot, the excise tax would apply at least to the extent that the boot gives rise to the recognition of gain by a shareholder. However, since the exception only applies to the extent that “no” gain or loss is recognized by a shareholder, the excise tax would appear to apply to the full amount of boot received by a shareholder if the shareholder recognizes any gain on its stock as a result of the reorganization (i.e., even if the amount of gain recognized is less than the amount of boot received). Furthermore, the parties to a reorganization involving a target corporation whose stock is publicly traded are unlikely to know any particular shareholder’s tax basis in his, her, or its stock in the target corporations, and thus cannot be expected to know whether a particular shareholder has realized gain or loss (let alone the amount of gain) in the target stock. Without this information, the excise tax can be expected to be imposed on the full amount

of boot issued in the reorganization. Moreover, subjecting the full amount of stock acquired with the boot would appear to be consistent with the underlying intent of the excise tax.

Additionally, the House bill does not appear to contain an exception for a corporation's acquisition of its stock for stock of a controlled corporation in a "split-off" under section 355 to the extent such distribution does not occur in connection with a reorganization under section 368(a)(1)(D).

Finally, we note that Senator Brown and Finance Committee Chair Wyden introduced a standalone bill (S.2758) that would impose a 2% excise tax on stock buybacks. S.2758 would also apply to repurchases of options, would not apply to Covered Purchases by foreign Specified Affiliates, would reduce the amount on which the excise tax is imposed by the value of any newly issued stock of any Covered Entity (i.e., would not be limited to stock issued to employees in the case of Covered SFCs and Applicable FCs), and would not contain an exception for Covered Transactions entered into by RICs or REITs. The Senate has not yet considered this proposed legislation.

Limitations on deduction for interest expense

The House bill includes multiple provisions dealing with limitations on deducting business interest expense. The JCT has estimated that these proposed changes collectively would raise approximately \$27.9 billion over a 10-year period.

New section 163(n)

See [International section](#) of this report for a discussion of proposed new section 163(n).

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 only 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.

Consistent with the previous Ways and Means proposal, the House bill would apply section 163(j) at the partner level rather than the partnership level. The House bill provides that the small business exemption from section 163(j) would not apply with respect to a partner's allocable share of business interest expense or other items from a partnership that does not meet the gross receipts test to qualify as a

small business.

The House bill would provide Treasury with authority to prescribe regulations or other guidance to address (1) restricting the allocation of business interest expense and other items, (2) reporting requirements, and (3) the application of the proposal to tiered structures or excepted trades or businesses.

Significantly, the House bill does not include the 5-year business interest carryforward limitation that was included in the Ways and Means proposal. As such, under the House bill, disallowed business interest expense would be carried forward indefinitely, as is the case under current law.

The House bill's changes to section 163(j) are proposed to apply to tax years beginning after December 31, 2022.

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 excepted trade or business or at the partner level where the section 163(j) limitation would ultimately apply. As noted, guidance on the application of the proposal to excepted businesses would be provided in regulations.

The small business exemption would presumably be applied at the partner level. However, a partner that would qualify for the small business exemption (an "exempt partner") would continue to be subject to section 163(j) with respect to the exempt partner's allocable share of business

interest expense, items comprising adjusted taxable income, and business interest income (“partnership section 163(j) items”) from a partnership that does not meet the gross receipts test to qualify as a small business under section 163(j)(3) (a “non-exempt partnership”). Although not entirely clear, the proposal does not appear to require a separate section 163(j) calculation for an exempt partner’s share of partnership section 163(j) items for each non-exempt partnership in which the exempt partner holds a partnership interest. If that is the case, an exempt partner would aggregate partnership section 163(j) items from all non-exempt partnerships for purposes of computing a section 163(j) limitation. Assuming the small business exemption determination is made at the partner level, it seems that a non-exempt partner would not be able exempt the partner’s share of business interest expense from a partnership that would meet the gross receipts test to qualify as a small business under section 163(j)(3). These issues might be clarified in regulations if the proposal is enacted.

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) under the House bill 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

Consistent with the Ways and Means proposal, the House bill would include a transition rule for partners that have been allocated excess business interest expense. For tax years beginning after December 31, 2022, 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.

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).

Application to S corporations

As with the Ways and Means proposal, the House bill 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. Similar to the partnership proposal, a shareholder that would qualify for the small business exemption would continue to apply section 163(j) to the shareholder's share of business interest expense, items comprising adjusted taxable income, and business interest income from an S corporation that would not meet the gross receipts test to qualify as a small business.

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.

International provisions

Refer to the [glossary of terms](#)

Interactions between the House bill international proposals and BEPS 2.0

In parallel with the release of the House bill, 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 House bill 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 House bill that most directly intersect with the OECD initiative are the revisions to the GILTI and BEAT regimes, both of which relate to Pillar Two. In general, the proposed revisions, as discussed more fully below, would bring GILTI 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 GILTI proposal, including the minimum rate, is significantly more aligned with the OECD IIR than the Green Book. 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.” An October 8 letter from three additional Democrats again urged Speaker Pelosi and Chairman Neal to “not move before the rest of the world on implementing a new GILTI regime.” The House bill’s international proposals seem designed, in part, to address such concerns by deferring the effective date of most international provisions to tax years beginning in 2023 (rather than 2022 under the Green book and Ways and Means proposal) and by including a GILTI rate that is broadly consistent with Pillar Two, while retaining an (albeit reduced) exclusion for tangible property and providing for foreign tax credit and loss carryforwards. As discussed below, however, the GILTI proposal is still harsher than the OECD IIR in some respects.

With respect to Pillar One, the House bill 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.”

KPMG observation

Interactions with Pillar Two. In its October statement, the Inclusive Framework agreed that the minimum rate applicable for the IIR and UTPR would be 15%, determined on a jurisdictional basis, with a formulaic substance carve-out equal to 5% of tangible assets and payroll (for a 10-year transition period those amounts will be 8% of tangible assets and 10% of payroll, with both percentages declining over the 10-year period). 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 will be given to the conditions under which the U.S. 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 regime 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 15%. The proposal would move GILTI to a jurisdiction-by-jurisdiction approach and increase the effective rate to 15.015%, 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 (under GILTI the carve-out is only for tangible property and it was reduced under the proposal from the current 10% to 5%) 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 House bill is 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 House bill 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. Members of the Inclusive Framework will likely see this 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 up to a maximum of 15% 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 exist between BEAT and the UTPR, however, including, at the most basic level, the 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 (though 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 U.S. 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 even consider the UTPRs of other jurisdictions, the result would be taxation above (or potentially below) the agreed minimum rate.

Finally, the House BEAT proposal diverges from 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 BEAT proposal in the House bill 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 House bill BEAT proposal (\$67B over 2022-31). Nonetheless, as discussed in detail below, the House BEAT proposal does include a feature designed to incentivize jurisdictions to adopt an IIR which was not included in the Ways and Means proposal.

The corporate AMT proposal also may be viewed as part of the broader U.S. effort to better align the U.S. tax system with Pillar Two by establishing a minimum rate of 15% for U.S. corporations that could potentially be subject to the UTPR by other IF members. The corporate AMT proposal shares many similarities to the anticipated effective tax rate (“ETR”) computation under Pillar Two in that both would use financial accounting income as the starting point for the denominator of the ETR calculation and apply 15% as the minimum applicable rate of tax. Nonetheless, the adjustments included in the new corporate AMT proposal diverge from the ETR calculation for purposes of the UTPR in a number of important respects. Specifically, although both regimes start with financial statement income in the denominator, there is no indication that all the adjustments to financial statement income proposed in the corporate AMT will also apply for purposes of the UTPR, and vice versa. Additionally, as proposed, the corporate AMT would allow general business credits to reduce the corporate AMT liability, whereas it is anticipated that the UTPR will not allow similar credits. Furthermore, while the corporate AMT would provide a credit for foreign taxes paid by CFCs only up to 15% of the book income attributable to those CFCs, this aspect of the proposal does not apply to branches or disregarded entities. As a result of these differences, a U.S. corporate AMT taxpayer could have an ETR lower than 15% for UTPR purposes and thus potentially be subject to the UTPR by other IF members.

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.

KPMG observation

Interactions with the OECD Forum on Harmful Tax Practices. Finally, while the House 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 House bill 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 House bill 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 House bill 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) certain foreign corporations with respect to which the U.S. 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 other than that of its owner, and 4) a direct or indirect branch of the U.S. taxpayer or a CFC that has a taxable presence in a foreign country other than the country of residence of its owner. The income that is attributed to a taxable unit that is tax resident (or located) in a country would be combined with income in the same separate limitation category of other taxable units in the same country for purposes of calculating the taxpayer's FTC limitation. These proposals would apply to tax years beginning after December 31, 2022.

The House bill 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," regulatory authority would be granted for coordination rules that would be necessary to assign items to an entity or arrangement that is considered a tax 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 House bill, consistent with the original Ways and Means proposal, generally applies the country-by-country approach to prevent cross-crediting with respect to "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 House bill would extend country-by-country separate limitation categories to all section 904(d) categories (after repeal of the foreign branch limitation category).

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 a U.S. taxpayer has 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. USP also receives general limitation royalty income from CFC X. 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 CFC X with its income earned for U.S. federal income tax purposes through DRE, also organized in Country X, in a single Country X general limitation category for purposes of computing its section 904(a) limitation. USP's general limitation for Country Y would be separately computed and would include only the subpart F income from CFC Y. USP's royalty income would be attributed to the USP taxable unit and combined with other general limitation income attributed to USP for purposes of computing a separate section 904(a) limitation.

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 taken 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 to determine foreign branch category income and apply the subpart F and GILTI high-tax exceptions. 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 successively 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 existing final regulations would allocate and apportion 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” to determine the effective tax rate imposed on the relevant tentative tested income item. The booking rule 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. However, the application of the booking rule is limited in scope to testing the effective tax rate of a tentative tested income item and does not apply more broadly for purposes of computing a CFC’s taxable income. 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 rule in the current GILTI high-tax exclusion regulations for allocating interest expense and the proposed regulations’ booking rule 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 for purposes of testing the effective tax rates in Country X and Country Y, 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 the 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

The House bill 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 from different countries 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 each being assigned to the general category. However, each of these items is expected to be attributed to a separate taxable unit — the high-taxed branch income to the taxable unit that is USP's Country X branch and the royalty to the taxable unit that is USP itself. 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 category 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 category. Because a taxpayer could have separate passive, general, and GILTI category income for each country in which it has a taxable unit, 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 for 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 to 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 (typically, the general category).

The House bill 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. In particular, solely for purposes of determining a taxpayer's income within the GILTI category, the proposal would limit the deduction items allocated to

income within the GILTI category to only: 1) the section 250 deduction, 2) the deduction allowed under section 164(a)(3) for certain taxes (e.g., state and local taxes) imposed on income within the GILTI category, and 3) any other deduction that Treasury determines is directly allocable to such income. Any deductions that would have been allocated or apportioned to income within the GILTI category for section 904 purposes would be allocated and apportioned only to U.S. source income. These proposals would apply to tax years beginning after December 31, 2022.

KPMG observation

Under the original Ways and Means proposal, only the GILTI section 250 deduction would have been allocated to GILTI category income. The current House bill expands the type of deductions that may be apportioned to the GILTI category for purposes of determining the GILTI FTC limitation to include the deduction for taxes described in section 164(a)(3) (state, local, and foreign income taxes). The House bill also provides Treasury with authority to identify certain directly allocable deductions to the GILTI category that should be taken into account. It is unclear which U.S. taxpayer expenses Treasury would identify as being directly allocable to such taxpayer's GILTI income under this grant of authority.

KPMG observation

The original Ways and Means proposal did not specifically address how to treat expenses—such as interest and stewardship expense—that would have otherwise been allocable to income within the GILTI category for purposes of determining the general and passive FTC limitations. The current House bill clarifies that such deductions are allocable to only U.S. source income. If a U.S. taxpayer's deductions exceed such taxpayer's U.S. source income, under the overall domestic loss rules of section 904(g), the taxpayer would be required to proportionately offset such "overall domestic loss" against its foreign source income within each section 904(d) category, including its income within the GILTI category. While the House bill provides preferential treatment of the GILTI category when allocating separate limitation losses, it does not do so for the allocations of overall domestic losses. This application of the overall domestic loss rules could result in the reduction to a taxpayer's FTC limitation within the GILTI category as if some or all of such deductions were actually allocated to the income in the GILTI category.

KPMG observation

By limiting the U.S. shareholder level expenses allocable to GILTI to the GILTI section 250 deduction, directly allocable taxes, and such other expenses identified by Treasury as being directly allocable to GILTI, 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 15.8% (equal to the amount of foreign tax necessary to offset U.S. tax at an effective rate of approximately 15% 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. As a policy matter, the enactment of section 163(n) in its currently proposed form could obviate some of the policy rationale for apportioning 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), and it therefore appears that interest expense would continue to be allocable to CFC stock for purposes of calculating passive and general limitation category income on a separate country basis. It should be noted that the House bill did add a new regulatory grant to the section 163(n) proposal that would allow Treasury to treat interest income that is subpart F income, and any interest expense of such corporation which is related to such income, as income and interest expense, respectively, of a specified domestic corporation for purposes of section 163(n), which if acted upon would prevent both section 163(n) and rules allocating and apportioning interest expense from applying to a CFC's interest income that is treated as 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.

As discussed above, the House bill treats expenses that would be apportioned to the GILTI category under current law but that cannot be taken into account for purposes of determining the GILTI category FTC limitation as allocated to U.S. source income. For this reason, the current rules for characterizing the value of CFC stock for purposes of allocating and apportioning interest and stewardship expense could remain unchanged, but would only serve the purpose of identifying such expenses that should be apportioned to U.S. source income (absent Regulatory changes). 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 continued to allocate interest and other deductions to CFC stock and then 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 full tax-exempt income (e.g., 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 such “excess credits” back one year and then forward in each of the 10 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 House bill would, on the one hand, narrow section 904(c) by eliminating the carryback period. On the other hand, the House bill would expand section 904(c) by providing that excess foreign taxes in the GILTI category can be carried forward. The carryforward period for GILTI basket taxes would be limited to five years for any tax paid or accrued in a tax year beginning prior to January 1, 2031. Thereafter, the 10-year carryforward period would apply to such taxes. This proposal would apply to taxes paid or accrued in tax years beginning after December 31, 2022.

KPMG observation

The current House bill proposal related to FTC carryforwards diverges from the original Ways and Means proposal. The Ways and Means proposal would have both eliminated the carryback period and reduced the carryforward period from 10 years to five years for FTCs in all section 904(d) categories (including GILTI).

KPMG observation

Differences between U.S. and foreign law regarding when items of income and expense are recognized are common. Applying the FTC limitation for each limitation category on a country-by-country basis would exacerbate the 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.

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 after the allocation and apportionment of U.S. level expenses. 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 a taxpayer’s SLL exceeds its SLI within all other 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. Conversely, section 904(g) and the regulations thereunder address instances in which a taxpayer has a U.S. source loss after the allocation and apportionment of expenses. A taxpayer with such an overall domestic loss (“ODL”) is required to apply such ODL to proportionately reduce its SLI in all categories. A taxpayer creates an SLL account when an SLL offsets SLI in another category, an OFL account when an SLL offsets U.S. source income, and an ODL account when an ODL offsets SLI in any category.

SLL and OFL accounts 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. ODL accounts are recaptured as foreign source income in a future tax year when the taxpayer has U.S. source income. Reg. § 1.904(g)-3 provides specific ordering rules regarding the recapture of SLL and OFL accounts and requires that the taxpayer recapture the SLI first as U.S. source income to recapture the OFL account 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 ODL account, future U.S. source income is recaptured as foreign source income in the category offset by the ODL pursuant to generally reciprocal rules.

The House bill would modify the current rules applicable to SLLs by expanding the definition of income category to apply to each category of income to which section 904 separately applies. Combined with the House bill proposal requiring a country-by-country application for each separate limitation category, this modification would require that SLLs also be determined on a country-by-country basis. Further, the proposal would also provide that the taxpayer must first allocate any SLL to offset SLI in each income category other than GILTI before allocating any amount to its SLI within the GILTI category. These proposals would apply to tax years beginning after December 31, 2022.

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 SLL and OFL recapture. Based on current rules for recapturing OFLs in Reg. § 1.904(g)-3, this change would limit the instances in which SLL and OFL account 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 account 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 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 the categorization of 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. The proposal directs Treasury to issue regulations or other guidance addressing such transition rules for both sections 904(f) and 904(g). When this same issue arose in the context of the TCJA, Treasury addressed such transition issues by providing guidance in regulations. Those regulations included simplified “safe harbor” approaches for transitioning pre-TCJA attributes to the post-TCJA FTC categories (mainly in the case of the new foreign branch category). Although, even a simplified approach to transitioning the above attributes is likely to involve a significant amount of complexity, given that this proposal would add a potentially very large number of per-country baskets whereas the “Tax Cuts and Jobs Act” (TCJA) added only the branch and GILTI baskets.

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. Also, the proposal's limitation of expense allocation to the GILTI category (as discussed above) should generally prevent the generation of SLLs with respect to the GILTI category. Notably, the House bill would not provide a separate rule for allocating ODLs first to non-GILTI category income. As a result, an ODL would continue to offset GILTI and non-GILTI income on a proportionate basis.

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 an FTC 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: (1) a change to the taxpayer's election to claim a credit or a deduction for foreign income taxes and (2) 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. This proposal would apply to changes that occur on or after the date which is 60 days after the date of the enactment of the proposal.

KPMG observation

The changes to section 905(c) appear consistent with proposed regulations issued on November 12, 2020 (85 Fed. Reg. 72078) 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 FTC or a deduction within the limitations period provided for by section 6511. Section 6511(d)(3)(A) would also be revised to provide that the extended period of limitation for a refund related to foreign income taxes only applies when the refund relates to an overpayment attributable to a "change in the liability for" foreign income taxes paid or accrued. This proposal would apply to taxes paid or accrued in tax years beginning after December 31, 2021.

KPMG observation

The current House bill's amendment to section 901(a) differs from the original Ways and Means proposal as it no longer references section 6511(d)(3)(A), which generally provides for a 10-year statute of limitations. As a result, the House bill proposal (which references section 6511) would generally limit a taxpayer to three years for either a change from deduction to credit or credit to deduction except, as noted immediately below, if a taxpayer has a change in the amount of its liability for foreign tax. Under current regulations, taxpayers generally have 10 years to change their election to deduct or credit foreign taxes without regard to whether the liability for foreign tax has changed.

KPMG observation

Section 6511(d)(3)(A), as revised, would only extend the period of limitation for a refund to 10 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 seemingly need to file an amended return to elect to claim a FTC 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.

KPMG observation

The Ways and Means proposal would have reduced the section 6511(d)(3)(A) limitation period for filing a claim for refund with respect to FTCs from 10 years to five years. Such a change would severely limit taxpayers’ ability to claim FTCs for foreign income taxes imposed as the result of foreign tax audits or tax contests. The shortening of such period would also be 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 House bill proposal does not adopt the Ways and Means proposal and retains a 10-year limitation period to claim a refund related to a change in foreign tax liability.

The proposal would revise section 6511(d)(3)(A) to provide that the 10-year limitation period for filing a claim for refund attributable to a FTC 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. This proposal would apply to taxes paid or accrued in tax years beginning after December 31, 2021.

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 FTCs runs from the statutory due date for the tax return for the tax year in which such taxes are paid, accrued, or deemed paid.

Base differences

Under current law, a foreign tax imposed on an item by a foreign jurisdiction that is not viewed as income from a U.S. tax perspective (a “base difference”) is assigned under the section 904(d)(2)(H) to the income category in section 904(d)(2)(B). Currently, section 904(d)(2)(B) refers to the foreign branch income category.

The House bill proposal would modify the rule for assigning foreign taxes imposed on base differences by granting Treasury authority to issue regulations or other guidance to assign foreign taxes imposed on a base difference to the proper category of income. This proposal would apply to tax years beginning after December 31, 2022.

KPMG observation

On January 2, 2019, Congressman Kevin Brady, then the chairman of the Ways and Means Committee, released a draft bill that included technical corrections to the TCJA. This bill would have, among other things, corrected the base difference rule to cross reference section 904(d)(2)(D)—the general limitation category. One might expect that current Regulations addressing the assignment of foreign income taxes to categories would be revised to cross reference the general category. However, with the House bill proposal to move to a country-by-country application of the separate limitation categories in section 904(d), additional guidance may be necessary on allocating the foreign taxes imposed on a base difference to both the correct section 904(d) category and country. It is important to note that current Treasury regulations define the term “base difference” very narrowly such that the occurrence of base differences for most taxpayers should be rare.

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 under 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.

KPMG observation

When Congress enacted section 338(h)(16) in 1988, it expressed concern that income from a sale of stock otherwise would be treated as foreign source income for foreign tax credit purposes, even though the target's jurisdiction likely would not tax the income (e.g., it 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 language of the proposal, however, is broad enough to create some ambiguity on this point. The proposal defines the scope of provisions that would be impacted as "this part," which technically extends beyond foreign tax credit rules to include the subpart F and GILTI rules. ("This part" meaning Part III of Subchapter N and covering Sections 901 through 989 of the Code.) A reference to this "subpart" (i.e., Subpart A of Part III, covering sections 901 through 909) would have more expressly limited the application to the FTC rules.

Nevertheless, the placement of the provision within section 904(b), the continued use of the phrase "source and character" in earlier descriptions of nearly identical proposals (see below), and the absence of any reference to subpart F or GILTI status in those descriptions, all suggest that the proposal's application is focused on the FTC implications. Indeed, changing the status of the seller's income as being subpart F or GILTI (or not) would be a significant expansion of the scope of section 338(h)(16) and thus inconsistent with the "principles" of sections 338(h)(16). This interpretation also is supported by the Joint Committee on Taxation's description of the earlier Ways and Means proposal, which describes the provision as applying for purposes of the foreign tax credit rules.

The proposal would generally apply to covered asset dispositions occurring after enactment. However, the proposal would not apply to a transaction made pursuant to a written binding contract that was in effect on September 13, 2021, and is not modified in any material respect thereafter.

KPMG observation

The proposal is similar (if not substantially identical) to, and presumably drawn from, earlier proposals in the Obama Administration's FY 2013-2017 Green Books, in Senator Baucus's 2013 tax reform package, the Biden Administration's FY 2021-2022 Green Book, and the Ways and Means proposal.

The proposal would create a significant tension with 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 banded 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 payments arising under section 367(d), the potential treatment of section 367(d) inclusions as U.S.-source income would appear to be a break with prior Congressional policy views in the area, but without recognition of that fact. Specifically, pre-1997 law expressly provided for U.S.-source treatment for section 367(d) deemed payments, but Congress removed that treatment in 1997. It would be curious at least for that decision to be reversed *sub rosa* through the proposal's enactment.

Significantly, the proposal would apply to transactions after enactment. This would be an accelerated timeframe relative to the other proposed modifications to the FTC limitations (applicable to tax years beginning after December 31, 2022). The proposal's effective date is also different from that of a similar rule in the Ways and Means proposal, which would have applied to tax years beginning after December 31, 2021 and did not contain a binding contract exception. The choice of the effective date for the binding contract exception indicates that Congress considers taxpayers to have been put "on notice" for the provision since the date of the Ways and Means proposal.

The JCT has estimated that the proposals modifying the foreign tax credit limitations would raise approximately \$12 billion over a 10-year period.

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 annually include in income a GILTI inclusion based in part on the CFC's tested income regardless of whether the income is repatriated to the U.S. shareholder. Under current law, a U.S. shareholder has a single GILTI inclusion computed on an aggregate basis across all of its CFCs. A U.S. shareholder's pro rata share of the aggregate of its CFCs' tested income is reduced by its pro rata share of the aggregate of its CFCs' tested losses to compute its net CFC tested income. Additionally, in determining its GILTI inclusion, the shareholder's net CFC tested income is reduced by its net deemed tangible income return. That net deemed tangible income return is 10% of a CFC's QBAI, reduced generally by the excess of certain interest expense over certain interest income taken into account in determining net CFC tested income. Further, corporate U.S. shareholders currently are allowed a deduction under 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 that results from QBAI or a tested loss of another CFC) may result in E&P that can 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 GILTI inclusions and associated foreign tax credits on a country-by-country basis. To achieve this result, the proposal generally would determine tested income, tested loss, net deemed tangible income return, and foreign taxes for each "CFC taxable unit", and then aggregate these items for the CFC taxable units within the same country to determine separate GILTI inclusions for each country. The U.S. shareholder's GILTI inclusion would be allocated to CFC taxable units for basis and previously taxed earnings and profits (PTEP) purposes. The proposal would generally import the taxable unit standard from the proposed FTC limitation rules described above for purposes of determining CFC taxable units. 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, 2022, and to tax years of U.S. shareholders in which or with which such tax years of foreign corporations end. The proposal is similar to a House Ways and Means proposal with minor modifications and with an effective date delayed by one year.

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 CFC taxable unit elsewhere in the structure has offsetting tested income earned within the same country. However, the proposal that would allow 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 CFC taxable unit operating at a tested loss in a country, such taxpayer may be unable to repatriate PTEP resulting from the tested income of a CFC taxable unit of the same CFC in a different country where the tested loss causes the CFC's E&P to be less than the taxpayer's PTEP. As a result, for example, a distribution from the CFC in excess of its E&P would be treated as a return of capital (to the extent of basis), which would result in different FTC consequences and foreign exchange gain or loss consequences as compared with a PTEP distribution.

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 country-by-country 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. After enactment of the TCJA, Treasury and the IRS initially increased the number of PTEP categories to 16 and then reduced the number of categories to 10, four of which are related to section 965 and will be eliminated after the section 965 PTEP currently in the system is distributed. Treasury and the IRS should continue the approach of reducing PTEP categories rather than expanding PTEP categories. The benefit of applying the FTC and foreign exchange gain or loss rules based on a tracing approach does not justify the complexity of tracking the large number of PTEP accounts that would be created if the existing PTEP categories were required to be maintained on a country-by-country basis.

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.

As described above, under the proposal's country-by-country approach, tested losses of a CFC taxable unit in one country would be permitted to offset tested income of a CFC taxable unit in that same country. The proposal also would introduce a new rule to allow a U.S. shareholder to carry over its net

CFC tested loss for a tax year (which would reflect any carryover of a net 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 net CFC 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 net CFC tested loss carryforward rule would require that proper adjustments be made in the allocation of a GILTI inclusion to CFC taxable units to take into account a decrease in a U.S. shareholder's GILTI inclusion as a result of the use of a net CFC tested loss carryforward. The proposal would apply to tax years of foreign corporations beginning after December 31, 2022, and to tax years of U.S. shareholders in which or with which such tax years of foreign corporations end. The proposal is similar to a House Ways and Means proposal with minor modifications and with an effective date delayed by one year.

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 net CFC tested losses may be carried forward by a U.S. shareholder to the succeeding tax year but does not provide for carrying any net 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 (a CFC taxable unit) 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, U.S. shareholder would not be able to carry back any portion of CFC's Year 2 net CFC tested loss to offset Year 1 tested income and reduce its Year 1 GILTI inclusion.

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, 2022. The proposal is substantially identical to a Ways and Means proposal but with an effective date delayed by one year.

Reduction in net deemed tangible income return

The proposal would amend the calculation of net deemed tangible income return by generally 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, 2022, and to tax years of U.S. shareholders in which or with which such tax years of foreign corporations end. The proposal is substantially identical to a Ways and Means proposal but with an effective date delayed by one year.

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. Consistent with the Ways and Means proposal, the proposal preserves the concept, but generally cuts in half the deemed return on QBAI. One explanation for QBAI's survival may be that the drafters were seeking some alignment with the OECD's Pillar Two, which as mentioned above, currently includes an 8% return on tangible assets and 10% return on payroll, which will phase down to a 5% return on tangible assets and payroll after a 10-year transition period.

Additional modifications to GILTI

Current law provides an exemption for foreign oil and gas extraction income (FOGEI) (including properly allocable deductions) in determining a CFC's tested income and tested loss for GILTI purposes. The proposal would repeal the exemption, which would result in FOGEI and expenses allocable to FOGEI being taken into account in determining tested income and tested loss. The proposal is substantially identical to a Ways and Means proposal but with an effective date delayed by one year.

The proposal would provide general authority for guidance to be issued under section 951A as well as specific authority for guidance on certain issues, including appropriate adjustments to basis to reflect tested losses regardless of whether the tested loss is taken into account in determining a GILTI inclusion. The proposal would be effective for tax years of foreign corporations beginning after the enactment of the House bill with no inference as to the application of the Code in earlier tax years. The proposal is similar to a Ways and Means proposal with modifications to the specific grants of authority (including a grant of authority to provide for appropriate adjustments to tested income and tested loss calculations where property is transferred, or amounts are paid or accrued, between related parties that was not include in prior Ways and Means proposals) and the effective date, which was retroactive in the House Ways and Means proposal.

KPMG observation

Future regulatory guidance as to the appropriate adjustments for use of a tested loss could include reductions in the basis of a CFC to account for the economic loss of a CFC that was available to reduce the amount of a U.S. shareholder's GILTI inclusion from another CFC within the same country, generally 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. Rules requiring similar adjustments for tested losses, were proposed in October of 2018 but never finalized. As noted above, the grant of authority would allow for adjustments to be made even where the loss has not been taken into account in determining a GILTI inclusion. Given that CFC loss carryovers would be treated as attributes of the U.S. shareholder under the proposal, a loss carryover

attributable to a CFC may be utilized after the CFC giving rise to such carryover is sold (an issue not addressed in the prior proposed regulations because the carry-forward of tested losses was not possible at that time). The Secretary may find it appropriate even in such an instance to require a basis adjustment to account for the fact that the loss carryover remains available to the selling shareholder after the sale.

The proposal would provide a new coordination rule under which references to sections 951 and 951(a) in sections 959, 961, and 962 would include references to section 951A and 951A(a). The proposal would be effective for tax years of foreign corporations beginning after the enactment of the House bill with no inference as to the application of the Code in earlier tax years. The proposal is similar to a Ways and Means proposal with modifications to the effective date, which was retroactive in the House Ways and Means proposal.

The JCT has estimated that the proposals to modify the GILTI rules would raise approximately \$57 billion over a 10-year period.

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

Reduction in “haircut” and modification of inclusion percentage

Pursuant to current section 960(d), a U.S. shareholder that is a domestic corporation is deemed to pay certain foreign income taxes paid or accrued by a CFC that are properly attributable to the CFC’s tested income that is taken into account by the U.S. shareholder in determining its GILTI inclusion. In determining the amount of such taxes that are deemed paid, current section 960(d)(1) imposes two reductions on such amount. First, foreign taxes attributable to tested income includible in a corporate U.S. shareholder’s gross income as a section 951A inclusion are reduced to the extent that the U.S. shareholder’s inclusion percentage is less than 100% by multiplying the amount of such taxes by the inclusion percentage. A U.S. shareholder’s inclusion percentage is the ratio of the U.S. shareholder’s GILTI inclusion divided by the aggregate tested income of such U.S. shareholder. Second, only 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 remaining after the application of the inclusion percentage are deemed paid by such shareholder. The application of the inclusion percentage and 20% “haircut” reduce 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 House bill proposal would reduce the 20% haircut to 5%, increasing the percentage of tested foreign income taxes that are creditable. Further, the House bill proposal would modify the calculation of the inclusion percentage by changing the denominator from the aggregate tested income of the U.S. shareholder to the “net CFC tested income” of the U.S. shareholder. The proposal would apply to tax years of foreign corporations beginning after December 31, 2022, and to tax years of U.S. shareholders in which or with which such tax years of foreign corporations end. The proposal in respect of the haircut is substantially identical to a House Ways and Means proposal with an effective date delayed by one year.

KPMG observation

The U.S. tax rate on GILTI inclusions for corporate U.S. shareholders under the proposal would be 15.015% (the 21% corporate rate x (100% - 28.5% 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 approximately 15.80% to eliminate any residual U.S. tax on the U.S. shareholder's GILTI inclusion. The legislative history to the TCJA suggested 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 substantially reduce the allocation of expenses (other than the section 250 deduction, state and local taxes imposed on a shareholder's GILTI inclusion and any other deductions determined by the Secretary to be directly allocable to the shareholder's GILTI inclusion) to the GILTI basket, it appears substantially more likely 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 15.80% 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).

KPMG observation

Under current law, a U.S. shareholder's inclusion percentage is generally reduced as a result of tested losses or the reduction for the net deemed tangible income return. The proposal's modification to the definition of inclusion percentage would eliminate the impact of tested losses on the inclusion percentage because the denominator of the ratio would consist of the shareholder's *net* CFC tested income instead of the sum of the shareholder's pro rata share of positive tested income from each of its CFCs (unreduced by its pro rata share of tested losses). As a result, the proposal would serve to increase a U.S. shareholder's deemed paid taxes under section 960(d) by more closely aligning the amount of deemed paid credits with respect to a GILTI inclusion with the local country effective tax rate applicable to the underlying tested income. Consider the following example:

USP owns CFC1 and CFC2, each of which is organized in Country A. During the tax year, CFC1 earns \$100 of tested income and CFC2 has a \$75 tested loss and neither CFC has any QBAI. Under the tax law of Country A, CFC1 and CFC2 are permitted to net their income and loss resulting in a Country A tax base of \$25. Country A imposes tax at a rate of 20% on the \$25 foreign tax base resulting in \$5 of Country A tax. Under current law, USP would have a GILTI inclusion of \$25 with respect to CFC1 and CFC2. However, because USP's inclusion percentage would be only 25% (calculated as the \$25 GILTI inclusion divided by the \$100 of aggregate tested income), USP would be deemed to pay only \$1.25 of foreign taxes under section 960(d) (subject to an additional 20% haircut) and would be subject to residual U.S. tax on this inclusion despite that the local country rate is well in excess of 15.80%. Under the proposal, USP would have an inclusion percentage of 100% (calculated as the \$25 GILTI inclusion over \$25 of net CFC tested income) and would be deemed to pay all \$5 of Country A taxes (subject to a 5% haircut). As such, the proposal would more closely align the taxes deemed paid with respect to the GILTI inclusion with the local country effective tax rate.

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 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, 2022, and to tax years of U.S. shareholders in which or with which such tax years of foreign corporations end. The proposal is substantially identical to a House Ways and Means proposal with an effective date delayed by one year.

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.

KPMG observation

The proposal to assign foreign income taxes with tested losses, together with the current rule for determining a taxpayer’s pro rata share of a tested loss, could give rise to non-economic allocations of foreign taxes in cases where a CFC has multiple classes of stock outstanding and there are timing differences in the recognition of the CFC’s tested income for between U.S. and foreign tax law.

Credit for foreign taxes paid under an income inclusion rule

The House bill 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 is not itself a CFC 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, 2022, and to tax years of U.S. shareholders in which or with which such tax years of foreign corporations end. The proposal is substantially similar to a House Ways and Means proposal with minor modifications and with an effective date delayed by one year.

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 income inclusion rule (“IIR”) that is consistent with the OECD Pillar Two proposed approach “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 explicitly so limited but does require that the foreign entity paying tax on imputed income not itself be a CFC. 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 House bill 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 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. These proposals would apply to tax years of foreign corporations beginning after the date of the enactment of the House bill, and to tax years of United States shareholders in which or with which such tax years of foreign corporations end.

Finally, a 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. This proposal 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.

Each of these proposals is substantially identical to a House Ways and Means proposal, except that the Ways and Means proposal provided for a retroactive effective date. However, in relation to each proposal, the House bill includes language clarifying that each proposal should not be construed to create an inference with respect to the proper application of any provision of the Code with respect to any tax year beginning before the tax year to which such amendments apply.

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 albeit on a prospective basis.

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.

Disallowance of credit for foreign taxes paid or accrued with respect to a GILTI PTEP distribution

If a U.S. shareholder includes the tested income of a CFC within its gross income as GILTI, all or a portion of the E&P of such CFC related to such inclusion is treated as PTEP. On a subsequent distribution to the U.S. shareholder from the CFC out of its PTEP, the U.S. shareholder would be entitled to exclude such amount from its gross income. Further, subject to the usual limitations imposed under section 901, the U.S. shareholder would generally be entitled to credit any foreign income taxes actually paid on the PTEP (e.g., withholding taxes imposed on the U.S. shareholder under section 901 upon the distribution of such PTEP to it) or deemed paid by the U.S. shareholder on the PTEP (e.g., foreign income taxes imposed on an upper-tier CFC upon receipt of the PTEP from a lower-tier CFC that are eligible to be deemed paid under section 960(b)).

The House bill proposal would impose a 20% haircut on the credit otherwise allowed for foreign taxes paid under section 901 or deemed paid under section 960(b) with respect to GILTI PTEP. This proposal would apply to tax years of foreign corporations beginning after the date of the enactment of the House bill, and to tax years of United States shareholders in which or with which such tax years of foreign corporations end. Further, in relation to this proposal, the House bill includes language clarifying that it should not be construed to create an inference with respect to the proper application of any provision of the Code with respect to any tax year beginning before the tax year to which such amendments apply.

Finally, the proposal includes an amendment that would reduce the 20% haircut on foreign taxes paid or deemed paid on GILTI PTEP from 20% to 5%. This proposal would apply to tax years of foreign corporations beginning after December 31, 2022, and to tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

This proposal was not contained in a prior House Ways and Means proposal.

KPMG observation

Section 965(g) and the regulations thereunder apply a similar mechanism to disallow a portion of the foreign tax credits paid on section 965 PTEP to account for the reduced rate of U.S. tax imposed on a taxpayer's section 965 inclusion amount. No such provision was included in the TCJA to disallow a portion of the foreign taxes credits imposed on GILTI PTEP to account for the reduced

rate of tax imposed on GILTI.

KPMG observation

The applicability dates related to this proposal presumably are bifurcated to account for the delayed effective date of the reduction of the haircut in section 960(d) from 20% to 5%. Thus, if the House bill is passed in 2021, the 20% disallowance of the credit for foreign taxes imposed with respect to a GILTI PTEP distribution would align with the 20% haircut in section 960(d) that applies to tax years beginning before January 1, 2023. Once the 20% haircut is reduced to 5% for tax years beginning after December 31, 2022, the disallowance of the credit for foreign taxes imposed on a GILTI PTEP distribution would likewise be reduced to 5%.

The JCT has estimated that the proposals related to the deemed paid credit for taxes properly attributable to tested income would lose approximately \$27 billion over a 10-year period.

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

Reduced deduction

The House bill would reduce the amount of the section 250 deduction to 24.8% (from 37.5%) of FDII and 28.5% (from 50%) of GILTI and the corresponding section 78 gross-up. Given the general corporate income tax rate of 21%, the effective tax rate on FDII and GILTI would be 15.792% and 15.015%, respectively. For calendar year taxpayers, these changes would be effective for tax years beginning after December 31, 2022. For fiscal year taxpayers, a blended rate would apply to the year that includes December 31, 2022, based on the portion of the tax year that precedes January 1, 2023.

KPMG observation

Under current law, for tax years beginning in 2026, the effective tax rates on FDII and GILTI increase to 16.406% and 13.125%, respectively. The proposal would instead permanently increase the effective rates on FDII and GILTI, to 15.792% and 15.015%, respectively, beginning in 2023. As a result, for tax years beginning in 2026, the effective tax rate on FDII would be lower under the proposal than under current law (15.792% as compared to 16.406%), whereas the effective tax rate on GILTI would be higher under the proposal than under current law (15.015% as compared to 13.125%). In contrast, the Ways and Means proposal would have merely accelerated, beginning in 2022, the scheduled increase to the FDII and GILTI effective tax rates.

The proposed effective tax rate for GILTI of 15.015%, together with the proposal to reduce the foreign tax credit haircut to 5% (discussed below), would require a foreign effective tax rate in excess of 15.805% ($15.015\% / 0.95$) to have deemed paid taxes under section 960(d) at least equal to the 15.015% tax on the GILTI inclusion. In contrast, the minimum foreign effective tax rate to achieve that result under the Green Book and the Ways and Means proposal would have been 26.25% and 17.43%, respectively. In addition, under both the Green Book and the Ways and Means proposal, the increase to the GILTI effective tax rate would have been effective for tax years beginning after enactment. The decrease in the GILTI effective tax rate to slightly more than 15% (the agreed minimum tax rate for Pillar Two) and the delay in its effective date to 2023 (the agreed timeframe for implementation of Pillar Two) likely reflect the competitiveness concerns

expressed by moderate House Democrats in an August 4 letter to Chairman Neal, urging alignment with “the substance and timeline of negotiations at the OECD.”

Favorable treatment of taxpayers with unrelated losses

Under current law, for purposes of calculating a domestic corporation’s section 250 deduction for a tax year, the amount of its GILTI and FDII may not exceed its taxable income for that year (the “taxable income limitation”). In addition, under current law, a section 250 deduction is disregarded in determining the amount of an NOL arising from a tax year and the amount of an NOL that carries forward into a year (the “NOL-first ordering rule”). The House bill would eliminate both the taxable income limitation and the NOL-first ordering rule. These changes would be effective for tax years beginning after December 31, 2022.

KPMG observation

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. The NOL-first ordering rule causes a taxpayer with current year losses in a year or with an NOL that carries forward into a year to lose some or all of the benefit of its section 250 deduction for that year. In addition, the taxable income limitation causes a taxpayer 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 its 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 a year or decrease the amount of NOL carryforward absorbed in a year. This proposal is substantially identical to the Ways and Means proposal, except that the Ways and Means proposal would have been effective for tax years beginning after December 31, 2021.

Additional exclusions from deduction eligible income

Very generally, the deduction for FDII is calculated by reference to foreign-derived deduction eligible income (“FDDEI”), which is a subset of a taxpayer’s deduction eligible income (“DEI”). Under current law, DEI is defined as all gross income of a domestic corporation, less certain excluded categories of income—dividends, CFC inclusions, financial services income, branch income, and domestic oil and gas income—reduced by allocable expenses. The proposal would exclude three additional categories of income from DEI. Each of these exclusions is discussed below.

Passive income exclusion

The proposal would exclude from DEI any income described in section 904(d)(2)(B)(i) and (ii), determined without regard to the high-tax kickout in section 904(d)(2)(B)(iii)(II) (the “passive income exclusion”). Section 904(d)(2)(B)(i) and (ii) defines two categories of passive income for purposes of the foreign tax credit rules—(i) any income received or accrued which is of a kind that would be foreign personal holding company income (or “FPHCI”) under the subpart F rules and (ii) any amount includible in gross income under section 1293 with respect to passive foreign investment companies (“PFICs”) for which a “qualified electing fund” (“QEF”) election has been made.

KPMG observation

The Ways and Means proposal would have excluded these same two categories of passive income for purposes of FDII, but would have done so by repeating nearly verbatim the language in section 904(d)(2)(B)(i) and (ii) rather than by cross-reference. However, the House bill's indirect reference to FPHCI through section 904 would appear to incorporate into the determination of DEI not only the exclusions from FPHCI in section 954 (e.g., the look-through exception of section 954(c)(6)), as under the Ways and Means proposal, but also the exclusions from passive income in section 904 and the regulations thereunder. Most notably, the active rents and royalties exception in the section 904 regulations generally excludes rents or royalties derived in the active conduct of a trade or business from the definition of passive income, regardless of whether the rents or royalties are received from a related or unrelated person. By contrast, the active rents and royalties exception for FPHCI does not apply to rents and royalties from a related person, even if the rents or royalties are derived in the active conduct of a trade or business.

If the House bill becomes law, taxpayers will have to analyze, for purposes of calculating their FDII, each item of income to determine whether such income would be passive income within the meaning of the foreign tax credit rules. This analysis would have to be conducted regardless of which such income qualifies as FDDEI, because exclusion of even non-FDDEI DEI (known as "residual DEI" or "RDEI") from the formula prescribed in section 250 can impact the computation of FDII.

IP disposition exclusion

The proposal would exclude from DEI, except as provided in regulations, any income and gain from the sale or other disposition (including a deemed sale or other deemed disposition) of property giving rise to rents or royalties derived in the active conduct of a trade or business (the "IP disposition exclusion"). For purposes of this exclusion, the proposal does not define the term "sale," but provides that the broad definition otherwise generally provided for that term for purposes of FDII, which includes "any lease, license, exchange, or other disposition," does not apply.

KPMG observation

The proposed IP disposition exclusion represents a significant departure from current law. Under current law, FDDEI includes any income from a sale, license, transfer, or other disposition of intangible property to a foreign person for a foreign use. This proposed exclusion for "sold" intangible property may have been intended to be responsive to the observation in the Green Book that, under current law, FDII creates undesirable incentives to locate certain economic activity abroad. However, this proposal was not included in the Ways and Means proposal.

Even if a purpose for the proposal can be discerned, it remains difficult to ascertain its intended scope. In particular, the proposal appears to apply only to transfers of property that have given rise to active rents or royalties rather than intangible property generally. Thus, income from the sale of intangible property that a taxpayer had exploited to make and sell products would appear to fall within the exclusion only if the taxpayer also earned royalties from the property prior to its disposition. It is unclear what policy objective is advanced by denying a FDII deduction for the offshoring of licensed intangible property but not unlicensed intangible property.

As discussed above, the proposal applies to not only gain from the sale or other disposition of

intangible property, but also “income” from a “deemed sale” or “other deemed disposition” of such property. As articulated, the IP disposition exclusion would appear broad enough to exclude from DEI (and thus also FDDEI) a deemed royalty under section 367(d), which is income from the deemed sale of intangible property in exchange for contingent payments by reason of an outbound nonrecognition transfer of intangible property. Further, because the proposal does not include any exception for transactions entered into prior to enactment, section 367(d) inclusions after the effective date of the proposal could be excluded from DEI even if the transaction that gave rise to those inclusions occurred pre-enactment.

Disqualified ETI exclusion

The proposal would exclude disqualified extraterritorial income from DEI (the “disqualified ETI exclusion”). Disqualified extraterritorial income is defined as 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. 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 the date of enactment.

KPMG observation

In the Ways and Means proposal, the new exclusions from DEI were proposed to be effective for tax years beginning after December 31, 2017, consistent with the effective date of section 250 under the TCJA. The proposed retroactive date likely reflected the view that these exclusions from DEI were in the nature of “technical corrections” to the TCJA. 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, but that a technical correction may be required to effectuate that intent. All three proposed exclusions from DEI included in the Ways and Means proposal 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. In contrast, the House bill would make the DEI exclusions prospective, consistent with the other “technical corrections” in the proposal (e.g., reinstatement of section 958(b)(4)).

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, 2022.

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 foreign tax credit 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 bill becomes law, the long-term viability of the FDII regime is unclear. 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 \$144.3 billion over a 10-year period.

KPMG observation

The revenue estimate for the House bill is significantly higher than the estimate for the Ways and Means proposal, which was estimated to raise \$96.4 billion over the same time period, with most of the difference attributable to years after 2025. This is likely due to the fact that, as discussed above, the Ways and Means proposal would merely accelerate changes to the section 250 deduction scheduled to go into effect for tax years beginning in 2026, whereas the House bill would reduce the deduction for GILTI (beginning after 2022) relative to both the current deduction and the deduction that would take effect in 2026 under current law.

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, where the property is sold or purchased (as relevant) for use outside the CFC's country of incorporation. In general, an exception applies if the property is manufactured in the CFC's country of incorporation. 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" that is either a tax resident of (or, in the case of a branch, located in) the United States or is subject to U.S. federal income tax as a result of its activities in the United States. For this purpose, taxable unit and tax resident would be defined by reference to the definitions of those terms in the foreign tax credit proposal discussed above. 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, 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 as well as guidance to treat a CFC's pass-through entity or branch as a wholly owned subsidiary of a CFC.

The proposal also would revise the foreign base company sales income and foreign base company services income rules by providing that determinations of whether certain activities, such as manufacturing or the use of property, occur in the same country as the CFC would be based on the country in which the CFC is a tax resident (as proposed to be defined for foreign tax credit purposes), rather than the country in which the CFC is created or organized.

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. The proposal is similar to the House Ways and Means proposal with significant modifications.

KPMG observation

The proposal generally would limit transactions that generate foreign base company sales income and foreign base company services income to transactions involving related parties that are U.S. tax residents or subject to tax by reason of their U.S. activities, including pass through entities that are U.S. tax residents and branches that give rise to a taxable presence in the United States. 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 a question of which U.S. tax rate will apply) 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 that arise from the imposition of U.S. tax on foreign-to-foreign transactions in situations where 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

While focusing on a broad division between the U.S. and the rest-of-the-world in looking for a related party transaction, the proposal goes beyond the Ways and Means proposal by taking a much more nuanced jurisdictional view in determining whether a CFC that does transact with a related U.S. person is located in the same jurisdictions as its customers, suppliers or other counterparties in determining if it satisfies the same-country exceptions to the foreign base company sales and services exceptions. For making that determination, the proposal would adopt the new definition of tax resident in the FTC proposal.

KPMG observation

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

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 the 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 a 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 such stock on the last day of the year on which the corporation 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)) the stock on the last day of the CFC's year on 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 could 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 of a U.S. shareholder that 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 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 (1) 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; (2) are paid out of current earnings and profits; (3) are received by a U.S. person; (4) are received before the U.S. shareholder's period of ownership; and (5) 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 CFC's subpart F income with respect to such share generally is 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 (1) the portion of a dividend (determined without regard to the proposal) received from a CFC out of current year earnings and profits that would be eligible for a section 245A deduction; or (2) 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 in a similar manner the rules for calculating a U.S. shareholder's pro rata share of CFC tested items for GILTI inclusion purposes, 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 guidance under section 951(a) on determining the amounts included in gross income of U.S. shareholders, including guidance: (1) to treat a partnership as an aggregate of its partners; (2) to provide rules allowing a foreign corporation to close its tax year upon a change in ownership; and (3) 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 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 end, with no inference as to the application of the Code to earlier tax years. The proposal is similar to the Ways and Means proposal with minor modifications and a prospective effective date, which differs from the retroactive effective date in the Ways and Means proposal.

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 the TCJA. The proposal is 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 proposal would not impact the determination of a U.S. shareholder’s section 956 inclusion; a U.S. 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, which has the primary effect of measuring the 10% ownership threshold for subpart F and GILTI inclusions at the partner rather than partnership level, 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 authority to treat partnerships as aggregates for purposes of the pro rata share rules is consistent with the approach taken in the proposed rule.

Sections 959 and 961

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 regulatory 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 broadens the Secretary's regulatory 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 also would provide the Secretary with authority to provide for necessary or appropriate basis reductions under section 961(b), as well as necessary or appropriate guidance to carry out the purposes of section 959.

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. The proposal is similar to the Ways and Means proposal with significant revisions.

KPMG observation

The proposal would retain the current statutory language in section 961(c) that basis adjustments apply only for purposes of determining the amounts included in gross income under section 951. A separate proposal (discussed above in the GILTI proposal) would provide a coordination rule under which the reference to section 951 in section 961(c) would include a reference to section 951A. As a result of this coordination rule, the basis adjustments in section 961(c) would apply for purposes of determining GILTI inclusions as well as subpart F inclusions (notwithstanding the retention of the current statutory language that, in isolation, limits the adjustments to subpart F inclusions). 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.

The Ways and Means proposal would have eliminated the current law limitation entirely, which would have allowed the Secretary to provide that section 961(c) basis is basis for all U.S. tax purposes (such as for purposes of calculating earnings and profits).

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 as under current section 961(a) (which is unaffected by the proposal), but neither section 961(a) nor the proposed revisions to section 961(c) 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, which would allow the gain recognition rule of section 961(b)(2) 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 proposals to change the subpart F rules would raise approximately \$12 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, 2022. 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, 2022, 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, 2022 to December 31, 2022, and then would have a calendar tax year for 2023 and onwards. The transition rule also provides that any required change in tax year will be treated as having been initiated by the corporation and made with the Secretary’s consent. Further, the proposal grants authority for the Secretary to issue guidance for allocating foreign taxes tax accrued between the short tax year required under the transition rule and the prior tax year.

This proposal is similar to a Ways and Means proposal but with additional transition rules and an effective date delayed by one year. The JCT has estimated that the proposal would raise approximately \$6.706 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. The 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 2022 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, 2022 and the short period) along with two years of tax accruals (December 31, 2021 and December 31, 2022), 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.

Congress appears to have been made aware of this issue subsequent to the release of the Ways and Means proposal, which did not include any authority for transition year guidance. In lieu of addressing the issue directly through statutory changes, the proposal directs the Secretary to issue guidance on the allocation of taxes between the short-year created by the transition rule and the year immediately before the short-year. As an alternative to delegating to the Secretary the obligation to resolve the issue through allocation rules, the lost FTC issue could be addressed by revising the effective date of the GILTI FTC proposals to include FTCs that arise in the one-month short period.

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 proposal would apply to tax years of foreign corporations ending after the date the proposal is enacted, and to tax years of U.S. shareholders in which or with which such tax years of foreign corporations end. The proposal is substantially identical to a Ways and Means proposal but with a different effective date. The JCT has estimated that the proposal would raise approximately \$4.875 billion over a 10-year period.

KPMG observation

The effective date in the proposal (tax years *ending after* enactment) would make the provision retroactively applicable in some circumstances. For example, if the proposal is enacted into law prior to the end of 2021, then a calendar year CFC would be subject to the rule for all transactions that occurred during its 2021 tax year, including transactions that occurred prior to the issuance of the proposal. This is a change from the Ways and Means proposal, which would have made the change effective for tax years *beginning after* December 31, 2021. It is noteworthy that the current proposal could apply to transactions that were undertaken in the current tax year and that predate the earlier Ways and Means proposal.

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

Reinstatement of section 958(b)(4)

The House bill 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 tax years of foreign corporations beginning after the date of enactment and tax years of U.S. persons in which or with which such tax years of foreign corporations end.

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 (sometimes referred to as a “faux CFC”). 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 House bill would address the policy concerns that motivated the repeal of section 958(b)(4) with the addition of new section 951B, discussed in more detail below. Section 951B gives effect to the legislative history by only subjecting **related** U.S. shareholders of faux CFCs to the CFC inclusion rules.

KPMG observation

The Ways and Means proposal also would have reinstated section 958(b)(4), albeit with a different effective date. Under the Ways and Means proposal, the effective date was the same as the repeal of section 958(b)(4) under the TCJA. Thus, the Ways and Means proposal would have

treated section 958(b)(4) as having never been repealed. The prospective effective date of the House bill alleviates many of the administrative and compliance burdens that a retroactive reinstatement of section 958(b)(4) would have created. For example, under the retroactive rules of the Ways and Means proposal, U.S. shareholders of faux CFCs not subject to the CFC inclusion rules under section 951B (because they are not “foreign controlled” U.S. shareholders) would have been required to redetermine their tax liability (and resulting tax attributes) for tax years between 2017 and 2021.

Rules applicable to foreign controlled CFCs

The House bill would add new section 951B, which would apply the CFC inclusion rules to “foreign controlled U.S. shareholders” (“F-USSH”) of “foreign controlled CFCs” (“F-CFC”). 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 or value of the F-CFC, 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 that is not a CFC would be an F-CFC if more than 50% of its voting power or value was owned by an 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.

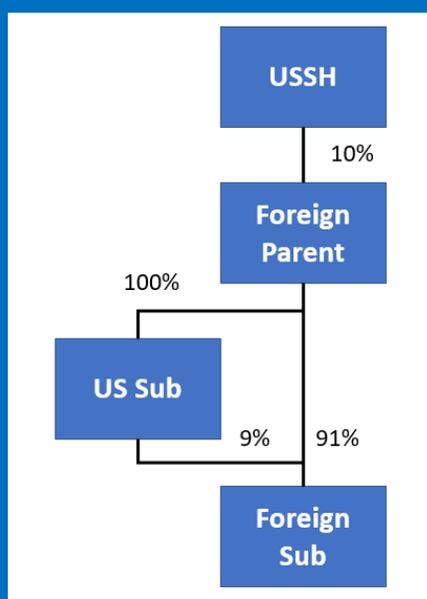
Generally, an F-USSH of an F-CFC would be subject to the CFC inclusion rules in the same manner as a U.S. shareholder is subject to those rules with respect to a CFC. Accordingly, an F-USSH would be subject to the CFC inclusion rules under section 951B only if it owns stock in the F-CFC directly or indirectly 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 guidance (1) to treat F-CFCs as CFCs and F-USSH as U.S. shareholders, respectively, for other purposes of the Code (e.g., sections 245A and 1248) and (2) to prevent avoidance of the purposes of section 951B.

Similar to the reinstatement of section 958(b)(4), section 951B is proposed to be effective for tax years of foreign corporations beginning after the date of enactment and tax years of U.S. persons in which or with which such tax years of foreign corporations end.

KPMG observation

Taxpayers that would be affected by the repeal of section 958(b)(4) would need to review their structures to determine whether they would be subject to section 951B. The diagram below illustrates the scope of section 951B under the House bill:



In this diagram, U.S. Sub owns (under section 958(a)) 9% of Foreign Sub. Based on the proposed reinstatement of section 958(b)(4), U.S. Sub would not be treated as owning the Foreign Sub stock owned by Foreign Parent. Thus, U.S. Sub would not be a U.S. shareholder of Foreign Sub and Foreign Sub would not be a CFC. But under proposed section 951B, U.S. 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 U.S. Sub as an F-USSH and Foreign Sub as an F-CFC. As a result, U.S. 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. To the extent Foreign Sub has residual income that is not subject to tax under section 951B and are distributed to U.S. Sub, U.S. Sub would appear to be subject to tax on those amounts. This is because, as discussed below, an F-CFC is not a CFC and an F-USSH is not a U.S. shareholder for all purposes, including for section 245A purposes.

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, Foreign Sub would be an F-CFC, as discussed above, but USSH would not be an F-USSH of Foreign Sub, 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). Thus, absent the election under section 957 to treat Foreign Sub as a CFC discussed in more detail below, USSH would not be subject to the CFC inclusion rules.

This table summarizes the treatment of U.S. Sub and USSH under prior, current, and proposed law:

	Pre-TCJA	Current Law	House bill
US Sub	CFC inclusion rules did not apply	CFC inclusion rules apply	CFC inclusion rules would apply under section 951B
USSH	CFC inclusion rules did not apply	CFC inclusion rules apply	CFC inclusion rules would not apply

KPMG observation

The House bill 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

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 House bill would amend section 957(a) to permit taxpayers to make an election to treat a foreign corporation as a CFC for all purposes of the Code. 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 the election is 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 any 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 House bill provides broad regulatory authority, including specific authority to address acquisitions 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 proposed to be effective for the last tax year of foreign corporations beginning after the date of enactment and tax years of U.S. persons in which or with which such tax years of foreign corporations end.

KPMG observation

Under the Ways and Means proposal, the CFC election was specifically made inapplicable for

purposes of section 951B. The House bill eliminated this specific prohibition, instead providing Treasury broad discretion to determine provisions for which the CFC election would be inapplicable. Nonetheless, it remains likely that Treasury would exercise its authority to prevent a CFC election from applying for purposes of section 951B. To illustrate the potential issue, assume FP owns 100% of USS, and FP, USS, and unrelated USX own 81%, 9%, and 10%, respectively, of FS. In this situation, if 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 be 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 Treasury to not limit the scope of the election) be able to entirely avoid the CFC inclusion rules.

KPMG observation

Requiring all U.S. shareholders and the relevant foreign corporation to join in making the election may raise difficulties where U.S. shareholders are unrelated to each other and / or to the relevant foreign corporation. In particular, it may be difficult for a minority U.S. shareholder of a foreign parent or of a foreign-controlled foreign corporation to convince the foreign corporation to make (or its foreign parent to permit) such an election, thereby subjecting the foreign corporation permanently to the U.S. CFC rules. However, this inconvenience is perhaps necessitated by the durability of the election; the election would apply with respect to any U.S. shareholder that purchases stock in the foreign corporation for which the CFC election was made. 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, subject to the U.S. shareholder satisfying the holding period requirements of section 246(c). The House bill would limit the section 245A DRD to dividends received from a CFC. Therefore, 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 amendments to section 245A 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 House bill 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 Treasury to issue regulations treating F-USSH and F-CFCs as U.S. shareholders and CFCs, respectively, for purposes of section 245A. It is hoped that Treasury would exercise its authority to do so; the failure to treat F-USSHs and F-CFCs as U.S. shareholders and CFCs for purposes of section 245A would result in even "residual" E&P being taxed at the full corporate income tax rate.

The narrowing of the section 245A DRD may have adverse consequences for domestic corporations that own 10% or more of the shares of a non-CFC foreign corporation, 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 House bill, 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 House bill 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 House bill would provide an election to treat a non-CFC as a CFC for all purposes of the Code. Assuming Treasury does not exercise its regulatory authority to the contrary, this election would allow a corporate U.S. shareholder 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

Corporate U.S. shareholders of specified 10% owned foreign corporations that will not be CFCs under the House bill, including foreign corporations that are currently faux CFCs, should consider whether it would be advantageous (or possible) to cause such foreign corporations to pay dividends before the enactment of the bill. A section 245A DRD would be available for pre-enactment dividends out of such CFCs' untaxed E&P, whereas post-enactment dividends out of that same E&P would be subject to U.S. tax at the full corporate income tax rate unless a CFC election is made for such foreign corporations.

The JCT has estimated that the House bill's changes to section 245A and the associated provisions would raise approximately \$451 million over a 10-year period.

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 House bill 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 U.S. 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 the date of enactment. The added, retroactive regulatory authority provided by the House bill generally aligns with the substance of the Section 245A Final Regulations—i.e., rules designed to target extraordinary disposition and extraordinary reduction transactions.

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 is received, the excess is treated as gain from the sale or exchange of the shares.

The House bill would expand the circumstances in which a corporate shareholder is required to make a basis reduction under section 1059 with respect to the non-taxed portion of a dividend from a CFC. Specifically, under a new proposed section 1059(g), any “disqualified CFC 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. A disqualified CFC dividend is any dividend paid by a CFC attributable to E&P which (a) were earned by such CFC during any period such corporation was not a CFC or (b) in the case of tiered dividends, are attributable to disqualified CFC dividends received by such CFC from another CFC.

In certain circumstances, the proposal would treat dividends attributable to E&P as disqualified CFC dividends even if such E&P were earned during a period the foreign corporation was a CFC. First, if a CFC earns E&P during a period in which it is less than 100% directly or indirectly owned by U.S. shareholders, the portion of the E&P attributable to non-U.S. shareholders is treated as earned by such corporation during a period it was not a CFC. For this purpose, domestic partnerships and, to the extent provided by Treasury, domestic trusts are not treated as U.S. shareholders. In addition, if a foreign corporation would not have been a CFC for tax years for which section 958(b)(4) was repealed, the proposal would treat the foreign corporation as if it were not a CFC during such years for purposes of

section 1059(g).

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

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 were never subject to the CFC inclusion rules because they are either (a) attributable to periods of ownership before the foreign corporation was a CFC or (b) attributable to a non-U.S. shareholder. Any dividend out of such E&P may qualify for 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. Therefore, in the case of a domestic corporation that acquires a foreign corporation that was not a CFC before the acquisition, if no section 338(g) election is made, it may be necessary to track separately pre-acquisition and post-transaction E&P at the CFC-level to determine whether section 1059(g) could apply to any subsequent distributions.

As noted above, a number of faux CFCs will cease to be treated as CFCs upon the reinstatement of section 958(b)(4). The House bill would treat untaxed E&P earned by such entities while they were faux CFCs as E&P earned by a non-CFC for purposes of section 1059(g), even if such E&P was attributable to a section 958(a) shareholder. If such an entity again becomes a CFC—e.g., though an election under section 957(a) to be treated as a CFC, any dividend of such E&P may be eligible for the section 245A DRD, but would be subject to the proposed expanded section 1059 rules. As a policy matter, it is unclear why the residual E&P of faux CFCs, after the application of the CFC inclusion rules, should be subject to the rules of proposed section 1059(g).

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

The Ways and Means proposal would have applied not only to E&P earned by a CFC during a period it was not a CFC, but also to E&P earned by the CFC “attributable to gain on property which accrued” during that period. Notably, any such gain would be subject to the CFC inclusion rules and thus most likely would generate PTEP that would not give rise to dividends subject to section 1059. The House bill would not expand section 1059 to apply to E&P attributable to the recognition of CFC asset gain accrued during a period the corporation was not a CFC.

KPMG observation

The Ways and Means proposal did not clearly provide for the treatment of tiered dividends. For instance, if an upper-tier CFC receives a dividend from a lower-tier CFC, such E&P would be earned by the upper-tier CFC while a CFC. But if the dividend from the lower-tier CFC were attributable to E&P earned by such corporation during a period while not a CFC, the Ways and Means proposal was silent as to whether the dividend from the upper-tier CFC to the U.S. shareholder would be considered a disqualified CFC dividend to the extent the dividend income did not become PTEP at the upper-tier CFC level – e.g., because it qualified for an exception to foreign personal holding company income under section 954(c)(3) or 954(c)(6). The House bill clarifies this ambiguity, treating as a disqualified CFC dividend the dividend from the upper-tier CFC to the U.S. shareholder to the extent attributable E&P created by the portion of the initial dividend from the lower-tier CFC that is a disqualified CFC dividend. This rule has the effect of moving the “taint” of the lower-tier CFC’s pre-CFC E&P to the upper-tier CFC for purposes of requiring basis adjustments with respect to the upper-tier CFC’s stock on the subsequent distribution of such E&P to the U.S. shareholder. It is presumed, however, that basis adjustments under section 1059 would not be required with respect to the lower-tier CFC stock if such dividend is not subpart F income by reason of section 954(c)(3) or 954(c)(6), because section 1059 applies only to the extent the dividend is afforded a dividends-received deduction under section 243, 245, or 245A.

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 that would more closely align the BEAT with the OECD’s work on Pillar Two and 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 OECD’s work on Pillar Two is briefly summarized above.

KPMG observation

The House bill would make several modifications to the BEAT regime. In one very significant change, discussed further below, the House bill would exclude from the definition of a base erosion payment any payment made to a foreign related party that is subject to U.S. tax, including through a subpart F or GILTI inclusion. This proposed change, along with more favorable treatment of foreign tax credits and net operating losses (NOLs), means that most U.S.-parented multinationals would no longer have a BEAT liability under the House bill.

Eliminate base erosion percentage test starting in 2024

The BEAT applies to “applicable taxpayers.” Under current law, a taxpayer must determine whether it is an applicable taxpayer annually. An applicable taxpayer is a corporation (other than a regulated investment company (RIC), real estate investment trust (REIT), or S corporation) that, together with certain related parties, has: (1) average annual gross receipts of at least \$500 million for the three

preceding tax years (the gross receipts test); and (2) 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. The proposal also would provide that if a corporation is an applicable taxpayer for any tax year beginning after December 31, 2021, it remains an applicable taxpayer for the 10 succeeding tax years.

KPMG observation

The proposal to eliminate the BE% test, which is materially unchanged from the Ways and Means proposal, would significantly increase the scope of applicable taxpayers subject to the BEAT. Eliminating the BE% test would move BEAT closer to the OECD's Undertaxed Payment Rule (UTPR) and the administration's SHIELD proposal, both of which would apply without regard to the level of a company's base erosion. Instead, those proposals would apply to any corporation that is a member of a financial reporting group with worldwide revenue in excess of certain thresholds (approximately \$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, could benefit 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 BEAT.

KPMG observation

The proposal for a taxpayer to retain its applicable taxpayer status for 10 years after any year in which it meets the relevant thresholds was not included in the Ways and Means proposal. If enacted, taxpayers that normally do not meet the gross receipts threshold would need to be extra vigilant in monitoring extraordinary transactions (or any year with unusually high gross receipts) that would breach the threshold, as such a transaction (or year) could cause them to be subject to BEAT for the next decade.

This rule would also limit the benefit of the BE% test for certain taxpayers, reducing the significance of its proposed repeal for tax years beginning after December 31, 2023. For example, a taxpayer that meets the gross receipts test and is above the 3% threshold in 2022 would be an applicable taxpayer for the 10 succeeding tax years, without regard to the application of the BE% threshold.

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: (1) the BEAT rate for the year multiplied by the taxpayer's modified taxable income (MTI), over (2) the taxpayer's regular tax liability, reduced 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 (1) its base erosion tax benefits for the year, and (2) the “base erosion percentage” of any net operating loss (NOL) deduction allowed for the year. The proposal would modify MTI by adding additional adjustments and revising the treatment of NOLs:

- Favorably, the adjusted basis of depreciable or amortizable property acquired with a base erosion payment would not be reduced for depreciation or amortization that is disallowed as a base erosion tax benefit, including for purposes of determining gain or loss if the property is later sold;
- The base erosion payment portion of certain inventoriable costs is removed from cost of goods sold (COGS); and
- 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 arising in a year beginning after December 31, 2021, without regard to any deduction that is a base erosion tax benefit, and (C) making conforming adjustments to determine the amount of any NOL carryover.

Additionally, “rules similar to the rules” of section 59(g) and (h) would apply unless the Secretary provides otherwise.

KPMG observation

Eliminating the reductions to the basis of property acquired with base erosion payments for the related depreciation or amortization that is disallowed as a base erosion tax benefit means such property would have a higher adjusted basis for MTI purposes than for regular tax purposes and, if sold, could result in less gain (or more loss) when computing MTI, thereby reducing or eliminating a taxpayer’s BEAT liability that might have existed in the absence of this special adjustment.

KPMG observation

Under current law, an applicable taxpayer with NOLs can have a BEAT liability for a year even if it never made a base erosion payment and has never had a base erosion tax benefit. This is because the BE% of a taxpayer is determined based on the BE% of the taxpayer’s aggregate group, and the portion of an NOL deduction that is added back to MTI is based on the aggregate group’s BE% for the year the NOL arose. Thus, current law can produce somewhat random results, depending, for example, on the extent to which a positive BE% is attributable to the base erosion tax benefits of other members of a taxpayer’s aggregate group or the extent to which a taxpayer owed BEAT as a result of adding back its base erosion tax benefits in the year the loss arose (such that there was no loss in MTI). The proposal would rationalize the treatment of NOLs by requiring taxpayers to determine and track a separate BEAT NOL that excludes the base erosion tax benefits that were allowed for regular tax purposes in the year of the loss. The base erosion tax benefits or BE% of the taxpayer’s aggregate group would no longer have any relevance to the treatment of NOLs.

Notably, the proposal only would require that base erosion tax benefits be removed from NOLs arising in a year beginning after December 31, 2021. Accordingly, there does not

appear to be any adjustment for NOLs arising in earlier years, including, importantly, post-TCJA years for which there would no longer be an add-back for the BE%.

Section 172 generally limits the amount of an NOL that a taxpayer may deduct to 80% of taxable income. The proposal would similarly limit 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 how the rules of section 59(g) and (h) would be reconfigured for MTI purposes. The same language appears in both the House bill and Ways and Means proposals without explanation in the relevant staff summaries or JCT technical explanation. 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).

Changes to the BEAT rate

Under current law, the BEAT rate is generally 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, 2022, and further increase the rate to 15% for tax years beginning after December 31, 2023, and to 18% for tax years beginning after December 31, 2024.

KPMG observation

Similar to the House bill, the Ways and Means proposal increases the BEAT rate over time. However, the House bill provides a top rate of 18%. Although none of the explanations or summaries of the Ways and Means proposal or the House bill mention the OECD's work on Pillar Two, the top 15% rate under the Ways and Means proposal aligned with the agreed Pillar Two global minimum rate of 15%. Under the Ways and Means proposal, however, the 15% rate would not have applied until 2026, at least two years after the targeted implementation date for the UTPR under Pillar Two. In contrast, the House bill would accelerate the 15% rate to align with the targeted implementation of the UTPR in 2024, but also would go a step further by raising the BEAT rate to 18% in 2025. Significantly, the new exception from BEAT for payments subject to sufficient foreign tax (discussed below) generally tests the foreign ETR against the applicable BEAT rate for the year, except that the threshold continues to be 15% after the BEAT rate increases to 18%. As a result, the 18% BEAT rate may be intended to function as a punitive rate to incentivize other jurisdictions to raise their rates to at least 15% by 2025. SHIELD arguably provided a much stronger incentive for other countries to raise their rates and/or adopt a Pillar Two compliant IIR, because it would have denied deductions at the full U.S. corporate tax rate, which the administration proposed to raise to 28% in the Green Book. However, the House

bill is not too far behind with its would-be claw back of 18% of payments subject to low tax, when compared with a 21% U.S. corporate rate.

Under current law, affiliated groups that include a bank or registered securities dealer are subject to a BEAT rate that is one percentage point higher than the generally applicable BEAT rate. The proposal would retain this rule and extend the higher BEAT rate to banks and registered securities dealers that are applicable taxpayers, regardless of whether they are members of an affiliated group, but only for tax years beginning after December 31, 2021, and before January 1, 2025. 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.

However, the proposal would also sunset the increased rate for banks and registered securities dealers for tax years beginning after 2024, when the 18% BEAT rate becomes applicable.

Changes to the treatment of tax credits

The proposal would modify the treatment of tax credits in determining the BEAT liability. Under current law, 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, the renewable electricity production credit, and the energy credit).

The proposal would amend the BEAT calculation to compare the taxpayer's MTI, multiplied by the BEAT rate, to its pre-credit regular tax liability with no downward adjustment for 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.-parented multinationals with significant foreign tax credits. Accordingly, the proposed favorable treatment of credits would for many taxpayers ameliorate what would otherwise be the most unfavorable consequence of removing the BE% test starting in 2024, which under current law is most important to U.S. companies that face a precipitous cliff if treated as an applicable taxpayer due to the unfavorable treatment of foreign tax credits under the current BEAT liability calculation.

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 and in determining its corporate AMT liability.

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 general business credits allowed 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.

Additionally, the corporate AMT proposed in the House bill (discussed in detail above) would be determined by taking into account any BEAT paid by the taxpayer for the year.

Expand scope of base erosion payments and base erosion tax benefits

Under current law, there are four categories of base erosion tax benefits, which are generally defined as deductions (or reductions to gross income in limited circumstances) attributable to the four corresponding categories of base erosion payments. These are generally:

- Deductions with respect to payments made to foreign related parties;
- Depreciation or amortization deductions with respect to property acquired from foreign related parties;
- Certain deductions and reductions in gross receipts relating to reinsurance payments to foreign related parties; and
- Reductions in gross receipts attributable to payments to recently expatriated entities.

Certain COGS treated as base erosion payments

The proposal would create two new categories of base erosion payments with respect to certain amounts allocated to a taxpayer's inventoriable costs that are recovered through COGS. First, amounts paid or accrued by the taxpayer to a foreign related party for either (1) indirect costs described in section 263A(a)(2)(B), or (2) amounts capitalized into the basis of depreciable or amortizable property, are base erosion payments to the extent that the indirect costs or depreciation deductions are required to be included in the taxpayer's inventory costs under section 263A(a)(1)(A). For example, a taxpayer that pays a foreign related party 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 party, for purposes of computing MTI, COGS would be limited to the foreign related party's (1) direct costs that can be traced to U.S. or unrelated persons, or that are otherwise subject to U.S. tax, plus (2) indirect costs paid directly to a U.S. or unrelated person, or otherwise subject to U.S. tax. For purposes of this rule, 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 allow a taxpayer to elect to 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, if a taxpayer acquires inventory from a foreign related party and elects the safe harbor, MTI would include COGS for the foreign person's direct costs that can be traced to U.S. or unrelated persons, or that are otherwise subject to U.S. tax, 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 deductions but instead are taken into account as reductions 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.

Base erosion tax benefits include depreciation (or amortization) on self-produced property

The proposal would also expand the second category of base erosion payments and base erosion tax benefits to include depreciation (or amortization) deductions for amounts paid to foreign related parties in connection with property produced by the taxpayer if the “amount is required to be capitalized under section 263A, including payments in respect of indebtedness or services.”

KPMG observation

This addition, which was not in the Ways and Means proposal, appears intended to provide parallel treatment between depreciable or amortizable property acquired from a foreign related party and self-produced depreciable or amortizable property, the adjusted basis of which includes certain amounts paid to foreign related parties.

Exclude 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 tax is imposed under Chapter One of the Code (i.e., sections 1-1400Z-2) “with respect to such amount” at the time of the payment or accrual, without regard to deductions allowed under sections 241 through 250 (special deductions for corporations). 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

Amounts paid to a CFC that are included in a U.S. shareholder’s subpart F and GILTI inclusions would be potentially eligible for this exclusion, regardless of whether a reduced rate of U.S. tax applies because of the section 250 deduction. This result is consistent with the JCT technical explanation and Budget Committee summary of the Ways and Means proposal, and the proposed statutory text has been clarified to make clear that the availability of a section 250 deduction would not alter the conclusion. Combined with the favorable changes to the treatment of foreign tax credits (and other credits), this exclusion means that many U.S.-

parented multinationals would not have a BEAT liability under the proposal.

The proposed statutory 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. The JCT technical explanation and Budget Committee summary of similar text in the Ways and Means proposal both state, however, that “outbound payments to a related party that are *included in the computation* of [] GILTI (without regard to the section 250 deduction) . . . are not base erosion payments” (emphasis added). This interpretation is also consistent 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 GILTI regulations helpfully interpret this language as providing that an item is treated as “includible” to the extent included in tested income. Nonetheless, it would be helpful for the legislative text to be clarified to better reflect this intent.

The Budget Committee summary of the Ways and Means proposal explains that payments to partnerships and payments subject to withholding tax are “determined using principles similar [to] those in former section 163(j)(5).” Former section 163(j)(5) provided an aggregate approach for partnerships and treated interest as tax exempt to the extent that a treaty reduced the U.S. rate, by comparing the reduction in the rate to the tax rate without the reduction. Under current law, aggregate treatment for partnerships is confirmed only in regulations; accordingly, the reference to former section 163(j)(5) could be read as a codification of that approach for purposes of determining whether a payment is subject to U.S. tax. Further, under the current BEAT 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 tax 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 structurally it no longer makes sense in light of the new broader exceptions for payments subject to U.S. tax or sufficient foreign tax, but the statutory reference to applying rules similar to former section 163(j)(5) for purposes of the exclusion for payments subject to U.S. tax appears intended to limit the application of the exclusion to payments subject to a reduced rate of withholding.

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 would not be 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 the high-tax kickout rule in section 904(d)(2)(F)—that is not less than the lesser of 15% or 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 applicable financial statements (as defined in section 451(b)(3)) unless the Secretary provides otherwise.

The proposal also would provide Treasury with broad authority to issue regulations, including to provide procedures for determining the ETR on an amount and to recharacterize transactions as necessary to carry out or prevent avoidance of the BEAT. Additionally, the proposal anticipates that, to the extent provided in regulations, a payment to a foreign related party would be treated as paid to

another foreign related party, if the payment “directly or indirectly funds” a payment to the second foreign related party and that party is subject to an ETR that is less than the lesser of 15% or the applicable BEAT rate.

KPMG observation

The exception for payments subject to sufficient rate of foreign tax would be set at 15% starting in 2024, which is in line with the agreed rate for Pillar Two. By including an ETR test in BEAT, the proposal would go a long way toward aligning BEAT with the goal of targeting low-tax operations, consistent with SHIELD and Pillar Two. 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 would be subject to development in future regulations. The base rule appears focused on individual payments; however, the ability to use financial statements appears (at least) to allow the determination of the ETR at the entity level and possibly at a jurisdictional or financial group level. Moreover, given that Treasury wrote the SHIELD proposal, which incorporated a jurisdiction-by-jurisdiction approach, it would not be surprising if Treasury used its broad authority to adopt a jurisdictional ETR test for BEAT. It is unclear whether the proposal’s grant of regulatory authority to prescribe procedures for ETR testing is broad enough to allow Treasury categorically to exclude payments that are subject to an IIR consistent with the Pillar Two recommendations.

The proposal would grant Treasury broad authority to recast transactions, for example, by looking through payments to high-tax jurisdictions to determine whether the payments fund the operations of low-tax entities in the group. This language in the House bill expands on the language in the Ways and Means proposal that would permit Treasury to prevent avoidance by recharacterizing the parties to a transaction. The reference to payments that “directly or indirectly” fund other payments parallels the language contained in the section 267A anti-hybrid regulations imported mismatch rules, suggesting a broader purpose than traditional anti-conduit rules. The imported mismatch rules have been subject to criticism for their complexity.

Modify statutory SCM exception

The proposal would provide that the “total services cost” of certain 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. Under the proposal, the BEAT SCM exception would be available for payments to foreign related parties that are either deductible or includable in COGS, but not for payments that a taxpayer capitalizes into the cost basis of self-produced depreciable or amortizable assets.

KPMG observation

The proposed changes to the existing statutory SCM exception appeared intended merely to confirm the approach in the current regulations that allows the “total services cost” component of an arm’s length charge for SCM-eligible services to qualify for the SCM exception from BEAT even when a markup is in fact charged. In addition, the Ways and Means proposal sensibly would have expanded the exception to also apply for purposes of the new COGS rule. The House bill would retain the SCM provision from the Ways and Means proposal without making conforming amendments to address the expansion of base erosion payments with respect to depreciable or amortizable property to include payments that are capitalized into the adjusted basis of self-produced assets. Thus, as proposed, the BEAT SCM exception would not apply to this new

category of base erosion payments, even if the payments would otherwise qualify for the SCM exception under section 482. This omission may have been unintentional, as it is difficult to discern a policy reason to allow the BEAT SCM exception to apply to some SCM-eligible services and not others.

Effective dates and revenue scoring

The proposed changes generally would apply to tax years beginning after December 31, 2021, with the exception of the scheduled rate increases and the elimination of the base erosion percentage test, which as noted above, would apply to tax years beginning after December 31, 2023.

KPMG observation

Unlike the delayed effective dates proposed for the GILTI and other international tax proposals, certain proposed BEAT changes would apply to tax years beginning in 2022. Some of the changes that would move the BEAT closer to Pillar Two, namely the elimination of the base erosion percentage test and the increase in the BEAT rate to 15%, would not apply until 2024. Notably, however, the new exception for payments that are subject to a sufficient foreign ETR would apply for tax years beginning in 2022, meaning that payments subject to at least a 10% foreign ETR (as determined under rules yet to be developed) would not be BEAT-able in 2022.

The JCT has estimated that the proposal would raise approximately \$67.088 billion over a 10-year period.

KPMG observation

This revenue estimate is modest in comparison to SHIELD, which the administration estimated would raise \$390 billion in revenue over nine years. Overall, it appears the House is balancing the need to raise revenue with a desire to make the BEAT both fairer to taxpayers and better aligned with the OECD initiatives. Thus, the proposal would raise revenue by eliminating the BE% test from the applicable taxpayer determination and by increasing the BEAT rate, but it would also reduce revenue by restoring the full value of credits and exempting certain payments subject to U.S. tax or a sufficient rate of foreign tax.

The Ways and Means proposal raised even less revenue, just under \$25 billion over the same period. The bulk of the difference in the revenue scores for the Ways and Means proposal and the House bill seems to be a result of the 18% BEAT rate that would apply to tax years beginning in 2025 and thereafter.

Limitations on deduction for interest expense

Section 163(n) in the House bill is substantially identical to section 163(n) in the Ways and Means proposal. As was the case with new section 163(n) in the Ways and Means proposal, new section 163(n) in the House bill would 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.

There are only a few significant differences as between new section 163(n) in the House bill as compared to new section 163(n) contained in the Ways and Means proposal: first, the effective date has been changed to tax years beginning after December 31, 2022, rather than 2021; second, various regulatory authorities have been added, including the authority to treat a CFC's Subpart F interest income and CFC interest expense allocable to Subpart F income as interest income and expense of a specified domestic corporation. The House bill also made changes regarding the section 163(o) disallowed interest carryover.

The JCT has estimated the proposal would raise approximately \$28 billion over a 10-year period.

KPMG observation

New proposed section 163(n) in the House bill, like proposed section 163(n) in the Ways and Means proposal, would apply both to foreign-parented groups and 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. It is unclear how U.S. ECI principles would be applied in the financial accounting context for EBITDA to parallel the application of the U.S. ECI rules for U.S. taxable income purposes, and it could potentially require additional work to reconstruct financial accounts in accordance with principles that have heretofore only applied in the U.S. tax accounting realm.

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 corporation's "allocable share" of the group's reported net interest expense ("GRNIE") divided by the domestic corporation's reported net interest expense ("DCRNIE"). The allocable share is the product of GRNIE times the ratio of (1) the domestic corporation's earnings before interest, taxes, depreciation and amortization ("EBITDA") to (2) the group's EBITDA, both as determined for that year and as reported in the financial statements. As a formula, the allowable percentage is $\{GRNIE * (\text{domestic corporation's EBITDA} / \text{group EBITDA})\} / DCRNIE$.

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).

KPMG observation

Since many U.S. multinationals may find themselves disproportionately leveraged in the United States under proposed section 163(n), those multinationals may try to "push down" debt into local jurisdictions to ensure that the United States is more proportionately leveraged. However, since many local jurisdictions have "unallowable purpose" and similar rules that prevent the deduction of interest on debt pushed-down in connection with an internal restructuring, such push-downs frequently will be feasible only if made in connection with an acquisition of a non-U.S. entity from a third party. In addition, there may be circumstances in which it is desirable to push debt down even without local country deductibility.

KPMG observation

Proposed section 163(n) would apply to domestic corps on an entity-by-entity basis (as opposed to taxpayer-by-taxpayer), such that a U.S. consolidated return group might not be treated as a single entity for this purpose based on the statutory text. This would be inconsistent with the application of 163(j), which applies on a taxpayer-by-taxpayer basis, and would seem to create potentially distortive results unless U.S. consolidated return groups pushed the debt to each member with earnings. The proposal as drafted may leave taxpayers in a similar situation to the period immediately after the TCJA with section 163(j), where they were required to compute the interest disallowance on an entity-by-entity basis until Treasury and the IRS issued guidance confirming that consolidated groups would be treated as a single group for this purpose.

KPMG observation

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 (except potentially for subpart F interest income subject to the exercise of regulatory authority) 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 non-interest 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 proposed section 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. The argument that proposed section 163(n) could be broadly applicable to CFCs seems even weaker due to the House proposal's grant of regulatory authority to treat CFC subpart F interest income and CFC interest expense allocable against subpart F income as items of the specified domestic corporation shareholder. By negative inference, the grant of such regulatory authority implies that proposed section 163(n) generally would not apply at the CFC level.

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, and the House proposal added to the list of regulatory authorities including (1) treating a CFC's Subpart F interest income and interest expense allocable to Subpart F income as items of a domestic corporation (as discussed above), (2) preventing the omission, inclusion, or duplication of any item or amount of interest income or interest expense, (3) providing rules for the application of new section 163(n) with respect to a domestic corporation that owns (directly or indirectly) an interest in an entity that is fiscally transparent in one or more jurisdictions (in addition to rules for a partner which holds (directly or indirectly) an interest in a

partnership), and (iv) providing rules for coordination with section 163(j)(4)).

The proposal also gives the Secretary authority 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.

KPMG observation

The new proposed regulatory authority treating a CFC's subpart F interest income and expense allocable to subpart F income as items of a domestic corporation was presumably added to recognize that interest income of CFCs taxed in the United States as subpart F income should not have further punitive effect under proposed section 163(n) if counted as CFC earnings. Nevertheless, there appears to be a disconnect here as all CFC interest expense allocable against all subpart F income would be swept in while only the CFC's subpart F *interest* income would be taken into account as U.S. earnings. Interestingly, a previous version of the House bill proposal (released on October 28, 2021) would have granted regulatory authority to treat *all* subpart F income and interest expense allocable to such income as items of a domestic corporation, which would have addressed the punitive effect concern more broadly. Query whether the change was prompted by other countervailing concerns that such a broader rule could incentivize converting GILTI earnings into subpart F income.

For the exceptions, a specified domestic corporation does not include a domestic corporation that (1) is an S corporation, REIT, RIC, or a small business under section 163(j)(3) or (2) 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.

KPMG observation

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.

KPMG observation

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.

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 disallowed under either section 163(j) or 163(n) similarly carries forward indefinitely.

KPMG observation

The House proposal's pivot to an indefinite carryforward (similar to current law), compared to the Ways and Means proposal's five year "use it or lose it" approach for disallowed business interest expense, is a taxpayer favorable change. This is especially the case in the event that the depreciation, amortization, and depletion addback to adjusted taxable income expires for tax years beginning on or after January 1, 2022, as failing to extend the addback would further limit the ability for taxpayers to deduct carryforward business interest expense.

The House proposal's adoption of an indefinite carryforward period is also significant for financial accounting purposes. The Ways and Means proposal's five-year restriction on carryforwards could have potentially resulted in significant valuation allowances on post-enactment interest expense carryforwards, whereas it is likelier that the inclusion of an indefinite carryforward period would cause the full amount of the disallowed interest expense carryforwards to be treated as DTAs for financial statement purposes.

Proposals related to the taxation of foreign fossil fuel income

Consistent with the 2021 Green Book and the Ways and Means proposals, the House bill would make two significant changes with respect to foreign oil and gas extraction income (FOGEI) and foreign oil related income (FORI). First, the House bill 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, the definitional changes would apply to tax years beginning after December 31, 2021. However, the House bill's proposed inclusion of FOGEI and FORI in tested income would apply one year later than under the Ways and Means proposal, instead applying to tax years of foreign corporations beginning after December 31, 2022, and to tax years of United States shareholders in which or with which such tax years of foreign corporations end.

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

$$A-B-C \times D/1-D$$

Factors in the formula are:

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

If a foreign country does not impose an income tax, the safe harbor method may still be elected, but the (D) factor in the above formula will be the lesser of the foreign dual capacity levy rate or the U.S. corporate rate, proposed to be a graduated rate between 18% and 26.5% and subject to clawback.

Consistent with the 2021 Green Book and the Ways and Means proposals, 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 House bill also includes a small change to the definition of a dual capacity taxpayer as drafted in the Ways and Means proposal, clarifying in a parenthetical that the country or possession from which the dual capacity taxpayer receives a specific economic benefit includes “any political subdivision, agency, or instrumentality thereof.”

The amendment to section 901(n) would be effective for amounts paid or accrued after December 31, 2021.

The JCT has estimated that the proposal would raise approximately \$6.7 billion over a 10-year period.

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 2021 Green Book and Senator Wyden's most recently introduced version of dual capacity taxpayer rule amendments 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 amendment makes no such distinction and appears to apply to all taxpayers. Accordingly, the House bill 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 Joint Committee on Taxation estimates that the House bill's dual capacity taxpayer proposal raises \$6.72 billion in revenue over the next 10 years—slightly more than the \$5.66 billion in revenue estimated under the Ways and Means proposal. However, this amount is significantly more than Treasury's "score" of the 2021 Green Book dual capacity taxpayer proposal (\$1.43 billion) and may reflect the treatment of treaty jurisdictions under the House bill.

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 House bill 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.

KPMG observation

The Ways and Means proposal's effective date language provided 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." That language suggested that such rules ought to apply only to controlled foreign corporations, although the rest of the provision is not so limited. The Joint Committee on Taxation's "score" of the provision as included in the Ways and Means proposal suggested that the provision would be effective for taxes paid or accrued in tax years beginning after the date of enactment. The House bill includes new effective date language,

clarifying that the changes would apply to amounts paid or accrued after December 31, 2021.

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 managers amendment added a new section stating that the amendments to section 996(g) shall not be construed to create any inference with respect to the tax treatment of gains realized and distributions made prior to January 1, 2022.

The JCT has estimated that the proposal would raise approximately \$915 million over a 10-year period.

International glossary

BE%	base erosion percentage
BEAT	base erosion anti-abuse tax
BEPS	base erosion and profit shifting
CFC	controlled foreign corporation
COGS	cost of goods sold
DEI	deduction eligible income
DRD	dividend received deduction
ETR	effective tax rate
ETI	extra-territorial income
EBITDA	earnings before interest, taxes, depreciation and amortization
FDDEI	foreign-derived deduction eligible income
FHTP	foreign harmful tax practices
FOGEI	foreign oil and gas extraction income
FORI	base erosion anti-abuse tax
FPHCI	foreign personal holding company income
FTC	foreign tax credit
GAAP	Generally Accepted Accounting Principles
GILTI	global intangible low-taxed income
IC-DISC	interest charge domestic-international sales corporation
IIR	income inclusion rule
IFRS	international financial reporting standards

JCT		Joint Committee on Taxation
MTI		modified taxable income
NOL		net operating loss
ODL		overall domestic loss
OECD		Organization for Economic Cooperation and Development
OFL		overall foreign loss
PFIC		passive foreign investment company
Pillar One		Pillar One of the OECD initiative would provide “market jurisdictions” a new taxing right that goes beyond the arm’s-length principle and permanent establishment standard.
Pillar Two		Pillar Two of the OECD initiative would secure a comprehensive agreement on a regime for global minimum taxation that is intended to ensure that all internationally operating businesses pay at least a minimum level of tax on their income in each jurisdiction regardless of where they are headquartered or the jurisdictions in which they operate.
PTEP		Previously-taxed earnings and profits
QBAI		qualified business asset investment
QEF		Qualified electing fund
R&D		research & development
REIT		real estate investment trust
RIC		regulated investment company
SCM		services cost method
SFC		Specified foreign corporation
SHIELD		stopping harmful inversions and ending low-tax developments
SLI		separate limitation income
SLL		separate limitation loss
UTPR		undertaxed payments rule

Other business tax provisions

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 securities loss in the year in which the securities become wholly worthless. For this purpose, a “security” generally includes a share of stock in a corporation, a right to subscribe for or receive a share of stock, and a bond, debenture, note, or certificate, or other evidence of indebtedness issued by a corporation (or government or political subdivision) with interest coupons or in registered form.

In general, worthlessness is established through an identifiable event.

Section 165(g)(1) provides that a loss from the worthlessness of a security which is a capital asset is treated as a loss from the sale or exchange, on the last day of the tax year, of a capital asset. Certain securities held by a domestic corporation are not treated as capital assets for these purposes. In particular, securities of an issuer are not treated as capital assets if both (1) the domestic corporate holder directly owns stock in the issuer that represents 80% or more of the total vote and value of the issuer’s stock and (2) more than 90% of the total historical gross receipts of the issuer were not from certain passive sources. A loss on a worthless security that meets the above requirements to not be treated as a capital asset is not subject to section 165(g)(1), including the timing rule.

Further, the consolidated return regulations generally provide that stock of a consolidated subsidiary is not treated as worthless under section 165 until one of certain specified requirements is met.

Current law also provides that a shareholder of a liquidating corporation generally recognizes gain or loss on its receipt of assets from the liquidating corporation in complete liquidation. 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, then the shareholder generally does *not* recognize gain or loss on the receipt of assets in complete liquidation. However, 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 (including liquidation preference on preferred stock) exceed the aggregate fair market value of its assets) is unable to undertake a complete liquidation, and even a corporate shareholder owning 80% or more of the stock of a liquidating corporation that is insolvent (including by reference to liquidation preference on preferred stock) may recognize a loss (*e.g.*, a worthless securities loss deduction) in connection with the liquidation.

Proposed amendments to section 165

The House bill would make several changes with respect to section 165(g).

First, it would amend section 165(g)(1) to provide that a subject loss would be treated as occurring at the

time of the identifiable event establishing worthlessness (rather than on the last day of the tax year).

KPMG observation

Under current law, the occurrence of an identifiable event, when coupled with closed and completed transactions evidencing the loss, generally fixes the year of a section 165(a) deduction. Section 165(g)(1) provides a special timing rule that applies to worthless securities that are capital assets, treating the worthless securities loss as arising on the last day of the tax year in which the loss is sustained. The House bill would require that the timing of a worthless securities loss subject to section 165(g)(1) be determined solely by the time of an identifiable event. The House bill does not appear to affect the timing of losses on a worthless stock or security that is not a capital asset, including by application of the affiliated corporation exception in section 165(g)(3).

It remains to be seen whether the proposed timing rule, if enacted, would introduce additional complexities. For example, in some cases courts have viewed a subsidiary's cessation of operations and winding up of affairs, followed by its commitment to sell its operating assets, to collectively comprise an identifiable event that dispelled any reasonable expectation of future value in the subsidiary's stock. When a series of events take place that collectively (but not individually) establish worthlessness, it may not be clear at which point the identifiable event that would determine the timing of the loss under the proposed rule is treated as having occurred. Furthermore, another uncertainty exists in limited situations where worthlessness is established through hopeless insolvency (*i.e.*, when 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 or expectation that its business will revive, thereby extinguishing any potential for the stock to become valuable). It would be very hard to pinpoint the precise date on which simple insolvency slips into hopeless insolvency.

In most cases it would not matter at what point in the tax year a security becomes worthless. 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 affect whether the loss is a short-term capital loss or a long-term capital loss. Timing may also matter where the shareholder is a partnership (or other pass through entity) that has a change in the composition of partners during the tax year, where the timing of the worthlessness may impact which taxpayer ultimately reflects the deduction.

In addition, the House bill would 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.

Further, the House bill would add a new section 165(m) to provide that a loss resulting from a worthless partnership interest is treated as a loss arising from the sale or exchange of the partnership interest at the time of the identifiable event establishing its worthlessness.

KPMG observation

This modification appears intended to create parity in the treatment of abandonment (as discussed below) and worthlessness of partnership interests. The proposed modifications to section 165 for losses arising from worthless partnership interests are substantially similar to the corresponding provisions in the previous Ways and Means proposal, except that the Ways and Means proposal expressly stated that the loss would be subject to the sale or exchange treatment "as provided in

section 741.” Under section 741, the character of the loss generally would be capital, except to the extent section 751 (relating to unrealized receivables and inventory items) applies. The House bill, however, does not include the “as provided in section 741” phrase.

The technical explanation supporting the Ways and Means proposal stated 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 stated that the sale or exchange treatment results from a deemed distribution as a result of a shift in liabilities under section 752 in connection with a worthlessness claim.

The Ways and Means proposal was intended to eliminate the perceived inconsistency in treatment based upon the presence or absence of partnership liabilities.

In fact, it is not clear that there is a shift in liabilities under section 752 solely because a partnership interest becomes worthless; 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. ¶150,371 (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.

Finally, the House proposal would provide that the abandonment of worthless securities is treated as an identifiable event establishing worthlessness for purposes of section 165(g) and section 165(m) (relating to worthless partnership interests).

KPMG observation

Current section 165(g) does not explicitly address the abandonment of securities (nor does it grant Treasury regulatory authority to issue guidance thereunder). Pre-2008 law distinguished between abandonment of a security (which generated an ordinary deduction) and worthlessness (the deduction for which might be capital if section 165(g)(1) applied). In 2008, Treasury promulgated Treas. Reg. §1.165-5(i)(1), which provides that, effective after March 12, 2008, a security that is abandoned is treated as worthless and any resulting deduction under section 165 would be potentially subject to the rules of section 165(g)(1).

This proposal may shore up the regulation as regards securities included in current section 165(g)(1) and would also impose similar (capital) treatment upon the abandonment of partnership interests and certain debt of a partnership.

On a separate note, it may be more difficult to “abandon” stock or securities than, for example, a traditional tangible asset. The preamble to Treas. Reg. §1.165-5(i) explains that a taxpayer need not relinquish legal title in all cases to establish abandonment; similarly, case law suggests that a taxpayer’s intention to abandon stock or securities can be relevant in determining whether and when an abandonment is treated as having occurred. Given that, under the House bill, the abandonment would constitute the identifiable event, which, in turn, would establish the time when a capital worthless stock or security loss is treated as sustained under the proposed timing rule, taxpayers can expect that the factual analysis supporting when an abandonment has occurred would be of

increased significance.

The provisions concerning the worthless securities loss deduction would be applicable for losses arising in tax years beginning after December 31, 2021.

Proposed section 267(h)

The House bill would introduce a new section 267(h) that would defer the recognition of losses on stock or securities of a liquidating corporation resulting from a “specified controlled group liquidation” (“SCGL”). As background, current section 267(f) (which is not modified under the House bill) defines a controlled group for purposes of section 267 by reference to the section 1563(a) definition, with modified constructive stock ownership rules and a “more than 50%” of vote or value stock ownership threshold. The following transactions with respect to any corporation which is a member of a controlled group would constitute SCGLs under the House bill:

- One or more distributions in complete liquidation (within the meaning of section 346) of such corporation,
- Any other transfer (or any series of transfers) of property of such corporation if any stock or security of such corporation becomes worthless in connection with such transfer(s), and
- Any issuance of debt by such corporation to one or more persons who are related to such corporation if any stock or security of such corporation becomes worthless in connection with such issuance.

Any transaction meeting the definition of an SCGL would be subject to the new proposed deferral mechanism, under which no loss is recognized by any member of the controlled group on any stock or security of the liquidating corporation until all property received by members of the controlled group in connection with the liquidation has been transferred to persons unrelated to the member who received the property.

The House bill would grant 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 deferral of losses on the stock or securities of a liquidating corporation within a controlled group would apply to liquidations occurring on or after the date of enactment.

KPMG observation

The House bill would defer the underlying loss on the stock or securities of a liquidating corporation until “all property” received by the members of a controlled group “in connection with” the liquidation event is “transferred” to one or more persons unrelated to the original recipients. In contrast, the corresponding Ways and Means proposal would have required only “substantially all” property received “in the liquidation” be “disposed of” to one or more unrelated persons. Under the House bill proposal, it could be important to track the properties of a liquidating or deemed liquidating corporation, to ensure that all of its properties—theoretically down to the last pencil or paperclip—can be shown to have been transferred. Moreover, it is unclear how this proposal would apply to wasting or other assets that become worthless while held by the controlled group, as worthlessness is not the same as a “transfer” to an unrelated person. This concern also suggests paying down all intercompany receivables owed to a liquidating entity prior to its liquidation to avoid the possibility that such receivables could not practically be transferred to an unrelated person. This

concern further suggests ringfencing cash and liquid assets received in a SCGL (given that money is fungible), to ensure such assets can be shown to have been transferred to unrelated persons. However, it is unclear whether, in determining whether all property of a liquidated entity received in a SCGL by members of a controlled group have been transferred, a replacement asset theory might apply, for example, to assets acquired with cash received in a SCGL.

Further, it is not clear how the requirement to dispose of “all property” would apply where members leave the controlled group. The departure of a controlled group member that had received property in a SCGL would not appear to allow the departing member (or any non-departing members who had losses in the stock or securities of the corporation that engaged in the SCGL even if they had not themselves received any assets) to recognize its deferred stock or securities loss, raising the question of when such loss would be allowed (e.g., would the departing member and its former group need to jointly determine, going forward, when all relevant property had been transferred in the aggregate?).

The deferral mechanism would apply with respect to stock or securities in a liquidating corporation. Given the proposal’s context, one might surmise that “securities” is intended to have a meaning that is largely congruous with the term’s meaning for purposes of section 165(g) (as opposed to the reorganization rules). However, the term is not defined in the proposal and it is not immediately obvious why a taxpayer’s loss on a debt security that is in registered form should be deferred whereas a loss on a debt security that is not in registered form would be allowed immediately.

The House bill describes three categories of transactions that would fall within the definition of SCGLs, triggering loss deferral, which is a significant expansion of the original Ways and Means proposal.

The first category is a distribution in complete liquidation of a corporation that is a member of the same controlled group. The proposed deferral of losses arising from this category of transactions is substantially similar to the corresponding provisions in the Ways and Means proposal, and it appears to be aimed squarely at *Granite Trust* planning.

At a high level, in a *Granite Trust* transaction a parent corporation attempts to recognize a loss on the stock of a subsidiary, and to avoid the application of the tax-free subsidiary by reducing its stock ownership below the relevant 80% threshold in section 332, 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 “old and cold” 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 transfers 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 all underlying assets must be transferred to unrelated parties to trigger recognition of the stock loss may significantly diminish interest in this kind of tax planning.

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 (who is not a member of the same controlled group as the liquidating corporation) 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.

KPMG observation

The second category of transactions that would constitute a SCGL is any non-liquidating transfer (including any series of transfers) of property of a corporation that is a member of a controlled group if any stock or security of such corporation becomes worthless in connection with the transfer. The section-by-section summaries prepared by the Committee staff describe this category as targeting the “dissolution of a corporation with worthless stock.” However, because the proposal applies only to worthless stock or securities loss deductions recognized in connection with the transfer of property, it appears to target transactions where stock that had no current liquidating value (due to insolvency) but was not yet wholly worthless (due to potential growth) becomes worthless as a result of the dissolution of the issuer. The proposal does not appear to impact the timing of a deduction for the worthlessness of stock or securities where such worthlessness is established by an identifiable event other than an SCGL. However, note that in the context of a consolidated group, Treas. Reg. § 1.1502-80(c) may prevent stock that is worthless from being treated as worthless in the meaning of section 165 until the occurrence of one of specified events. If the specified event that allows previously worthless stock to be treated as worthless under section 165 is an SCGL, a consolidated shareholder may find its deduction deferred under new section 267(h) notwithstanding that the stock was objectively worthless without regard to the SCGL.

Presumably, the proposal intends to defer losses that would otherwise be recognized on the stock or securities of an insolvent subsidiary where that subsidiary’s valuable assets remain in the controlled group (*e.g.* as in Rev. Rul. 2003-125, where a check-the-box election was made to treat an insolvent subsidiary as a disregarded entity, and the former subsidiary’s business continued after the election). Nevertheless, because the proposed language does not specify to whom the property is transferred, a literal reading of the language would suggest that a transfer of the subsidiary’s assets to anyone—including, for example, the subsidiary’s third party creditors, the subsidiary’s unrelated minority shareholders, or an unrelated buyer of assets—could constitute a SCGL if the subsidiary’s stock becomes worthless “in connection with” the transfer.

The third category of transactions that would constitute a SCGL is any issuance of debt by a corporation that is a member of a controlled group to one or more related persons if any stock or security of the issuing corporation becomes worthless in connection with the issuance. It is unclear what this provision is intended to address. General tax and economic principles (including general debt-equity principles, the section 385 regulations, and substance over form principles) would appear to limit the ability to issue debt to a related party in connection with a liquidation or other transaction in order to create or increase a worthless securities deduction. For example, a debt issued for an equivalent value of property would not be expected to increase insolvency. In

addition, a corporation's issuance of debt as a distribution to a shareholder in connection with its planned liquidation would (if respected for tax purposes) presumably be treated as a distribution of value to the shareholder, negating a worthless deduction on the stock. Potentially, the proposal could be intended to "backstop" general tax and economic principles. Alternatively (or perhaps additionally), the proposal could be aimed at limiting a taxpayer's ability to "plan into" a worthless stock deduction by intentionally forming and/or keeping a subsidiary thinly capitalized (e.g., capitalizing the subsidiary with significant related party / tiered-down debt and an insufficient amount of equity funding). Moreover, it is unclear why the proposed statute specifically references "debt" but not preferred stock, as preferred stock could be used to seemingly accomplish similar planning to the "debt" transactions that the provision could potentially address.

As noted, the second and third categories of SCGLs only apply if any stock or security of the transferor/issuing corporation becomes worthless "in connection with" the transfer of property or issuance of debt (as the case may be). This raises a series of issues. First, is this intended to apply to transfers for equivalent value? For example, if a corporation transfers \$100 (or property worth \$100) and receives in exchange money or property of equal value, can it be reasonably said that the corporation's stock or securities become worthless in connection with the transfer?

Second, how close a relationship in time or causation must there be in order for stock or securities to become worthless "in connection with" a transfer of property or the issuance of debt? The use of the present tense "becomes worthless" suggests a relatively close temporal relationship and a relatively close or proximate causal connection. In contrast, the "in connection with" suggests a more tenuous or even coincidental relationship. Is it necessary that the transfer of assets or issuance of debt be pursuant to the same plan as the generation (or realization) of worthless stock or security losses? Must the worthlessness be a direct consequence of a property transfer or debt issuance? The conjunctive use of both phrases in the operative language suggests that the proposal carries with it the potential for significant ambiguity, uncertainty, and conflict.

Revenue estimate

The above House bill proposals to modify the treatment of losses were estimated to collectively increase revenues by approximately \$1.78 billion over 10 years.

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 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 66.7% or more of the aggregate value, respectively, of all of D's or C's assets.

The House bill would further reduce the Adjusted Basis Limitation by the fair market value of any non-qualified preferred stock ("NQPS") and the total principal amount of C obligations (including debt securities) that are transferred to creditors (as amended, the "Amended Adjusted Basis Limitation"). More specifically, the House bill provides that section 361(b)(3) and (c)(3) do not apply to so much of the sum of (1) boot transferred to creditors and (2) the fair market value of NQPS and total principal amount of obligations of C (including debt securities) transferred to creditors (such sum of amounts (1) and (2), the "Non-Stock Creditor Consideration") as does not exceed (3) the excess of (a) the sum of the Non-Stock Creditor Consideration and the amount of liabilities assumed by C, over (b) the total tax bases of the assets transferred by D to C (such excess described in (3), the "Excess Section 361 Amount"). As a result, to the extent that the Non-Stock Creditor Consideration does not exceed the Excess Section 361 Amount (i.e., to the extent of the lesser amount), the House bill would require D to recognize built-in gain, if any (1) on the property contributed by D to C in an amount not in excess of the amount of boot (including non-security debt obligations of C) received from C in the exchange that is transferred to D creditors, and (2) on any NQPS and C obligations (including debt securities) received by D in the exchange and transferred to 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, except that the House bill would provide transition relief for transactions (1) subject to a binding written agreement as of such date, (2) for which a ruling request was submitted to the IRS on or before such date, or (3) described in a public announcement or a filing with the SEC on or before such date.

The proposal would be effective for reorganizations occurring on or after the date of enactment.

The proposal is estimated to generate revenue of approximately \$17.8 billion over the 10-year budget window.

KPMG observation

Sections 361(b)(3) and 361(c)(3), collectively, serve an important business function in Divisive Reorganizations by allowing D the flexibility to reallocate its debt between its continuing stay-behind business (or businesses) and the continuing business transferred to C. For example, consider a situation when D has a significant debt load and has historically financed its businesses through borrowings at the parent level – D may not be able or willing to service its historical debt load after spinning off a significant business, and traditional financial and business considerations might suggest that the distributed business include a reasonable amount of leverage. The debt reallocation flexibility, however, has led to certain transactions which have troubled the government and resulted in the enactment of various modifications of the Divisive Reorganization rules, while the Service has struggled with this and related issues and has periodically modified the no-rule

areas in its private letter rulings practice.

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 accompanying staff summary as well as the technical explanation of the prior Ways and Means proposal, the Amended Adjusted Basis Limitation 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 or other property that D may transfer to creditors and the amount of D liabilities that C may assume, but also the amount of C securities that D may transfer to creditors, to D's adjusted basis in assets transferred to C. By imposing such limitation, the proposal would further restrict D's ability to reallocate its debt to C on a tax-free basis in connection with a Divisive Reorganization.

The 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 \$70X; (3) C debt securities with the principal amount of \$60X; 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 \$60X 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 with a principal amount of \$60X; and (3) cash in the amount of \$20X.

Under current law, because 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 Basis Limitation (i.e., \$100X of tax basis in assets transferred to C – \$50X of D liabilities assumed by C = \$50X), D recognizes no gain on the contribution. The C debt securities transferred to the D creditors (\$60X) are treated as qualified property distributed to D shareholders with respect to which no gain or loss is recognized.

Under the House bill, because (A) the sum of (1) liabilities assumed by C in connection with the reorganization (i.e., \$50X of D liabilities assumed), (2) the amount of boot transferred by D to creditors (i.e., \$20X of cash), and (iii) the principal amount of C obligations transferred by D to its creditors (i.e., \$60X C debt securities), exceeds (B) the total adjusted bases of assets transferred by D to C (i.e., \$100X tax basis in assets transferred), the Excess Section 361 Amount is \$30X. As a result, section 361(b)(3) and (c)(3) do not apply with respect to \$30X of Non-Stock Creditor Consideration, and, thus, D may recognize gain not in excess of \$30X.

However, the proposed legislation does not provide for an allocation or stacking rule to allocate the Excess Section 361 Amount between boot and other Non-Stock Consideration. As discussed below, such allocation may affect the amount of gain recognized. The remaining analysis of the foregoing example assumes (for illustrative purposes) that the Excess Section 361 Amount is allocated first to boot and, then, to other Non-Stock Consideration. Under such assumption, D is, first, required to recognize any built-in gain with respect to the assets contributed to C to the extent that the amount of boot received by D in the exchange and transferred to creditors (i.e., \$20X of cash) does not exceed the Excess Section 361 Amount (i.e., \$30X). As such, in the example, D would recognize \$20X of the \$100X of built-in gain in the contributed assets under section

361(b)(1)(B). Second, D is required to recognize gain with respect to the distribution to creditors of Non-Stock Creditor Consideration other than boot (i.e., \$60X of C debt securities) with a principal amount not in excess of the remainder of the Excess Section 361 Amount (i.e., reduced by the amount of boot to which section 361(b)(3) does not apply under the Amended Adjusted Basis Limitation), under section 1001. Such recognition is required because section 361(c)(3) will no longer treat such amount of C debt obligations as distributed to shareholders and, therefore, such amount will no longer receive nonrecognition protection under section 361(c)(1). In the example, D would recognize built-in gain with respect to \$10X out of \$60X of C securities (i.e., \$30X Excess Section 361 Amount – \$20X cash subject to the Amended Adjusted Basis Limitation = \$10X C debt securities subject to the Amended Adjusted Basis Limitation).

To determine the amount of built-in gain in the \$10X of C debt securities subject to the Amended Adjusted Basis Limitation, we must determine the basis that D has in such C securities. D would have \$50X of transferred basis under section 358 that presumably would be allocated among the property permitted to be received tax-free by D in the contribution (i.e., the \$70X of C stock and \$60X of C securities) pro rata based on the fair market value. Assuming that the C securities in the example have a fair market value equal to their principal amount, 46% ($\$60X / (\$60X + \$70X)$) of the \$50X of basis would be allocated to the C securities, resulting in D having a basis of \$23X in the \$60X of C securities. Assuming that that basis is spread pro rata among the C securities, the \$10X of C securities that are no longer treated as distributed to shareholders under section 361(c)(3) would have a basis of \$3.8X (i.e., one-sixth of the total \$23X basis for all the C securities). Therefore, D would recognize \$6.2X of gain under section 1001 ($\$10X - \$3.8X$ of tax basis) on the distribution of the \$10X of C securities that are distributed to creditors and are not treated as distributed to shareholders under section 361(c)(3) because of new section 361(d)(3). Consequently, D would recognize a total of \$26.2X of gain as a result of the Amended Adjusted Basis Limitation proposal (\$20X gain on the contribution and \$6.2X on the distribution).

As mentioned above, the foregoing analysis assumes that the Excess Section 361 Amount should be allocated to boot before it is allocated to other Non-Stock Consideration, and the House bill does not indicate how that amount is to be allocated. As the example above illustrates, such allocation may affect the total amount of gain recognized because (1) in the case of recognition of gain by D on the contribution of assets to C due to receipt of boot to which section 361(b)(3) does not apply, the amount of gain that may be recognized may not exceed the amount of boot received, whereas (2) in the case of recognition of gain by D on the distribution of other Non-Stock Consideration to creditors to which section 361(c)(3) does not apply, the amount of gain that may be recognized depends on the basis of D in such consideration, which, in turn, depends on the basis of D in the assets contributed to C. Further guidance is needed to determine how the Excess Section 361 Amount should be allocated between boot and other Non-Stock Consideration when the total amount of Non-Stock Consideration exceeds the Excess Section 361 Amount.

As with the prior Ways and Means proposal, the House bill would apply the Amended Adjusted Basis Limitation to Divisive Reorganizations occurring on or after the date of enactment but also provides transition relief for certain transactions that have made substantial progress prior to such date, as discussed above.

Under the original proposed Ways and Means statutory language, the amount of C securities that D could receive and distribute tax-free remained unchanged (because the amount of gain remained limited to the amount of money and fair market value of other property distributed, although C obligations were to be taken into account in determining the Amended Adjusted Basis Limitation). In that regard, the legislative text in the prior proposal appeared inconsistent with the stated intent of the prior proposed amendments as described in the staff summary and the technical explanation. The revised Amended Adjusted Basis Limitation in the House bill appears to have

resolved that discrepancy. However, there remain differences between the treatment of C securities and the treatment of other non-stock property that is transferred to creditors under section 361, and the amount of gain that may be recognized may vary based on the composition of such non-stock consideration that is used to repay D creditors because C securities remain property that may be received without the recognition of gain under section 361(a). Nonetheless, given that the Amended Adjusted Basis Limitation limits the amount of C obligations that D may distribute to creditors tax-free, 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

The House proposal would revise section 856(d)(2) so as to prevent from being treated as qualifying rents from real property any amount 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 proposal would be effective for tax years beginning after December 31, 2021.

The JCT has estimated that the proposal would raise approximately \$55 million over 10 years.

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. An identical provision was included in the Ways and Means proposal.

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 (1) 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, (2) the recipient is a "10-percent shareholder" of the obligor within the meaning of section 871(h)(3)(B),

or (3) 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 House bill’s proposal (which is the same as the prior Ways and Means 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 approximately \$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.

Certain partnership interest derivatives

Current law

Under current section 871(m), amounts treated as “dividend equivalents” are treated as U.S. 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 U.S. source dividend arising from (1) a substitute dividend payment made pursuant to a securities lending or sale-repurchase transaction, (2) payments made pursuant to a “specified notional principal contract,” (3) 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 (except for income attributable to dividends on underlying securities held by certain partnerships).

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 U.S. trade or business, the income is treated as “effectively connected” with the conduct of a U.S. trade or business, which is taxable at rates generally applicable to U.S. taxpayers. Treas. Reg. section 1.863-7(b)(3).

The proposal

The proposal in the House bill is similar to the prior Ways and Means proposal but includes minor modifications.

Under the House bill proposal, any payment made pursuant to a specified notional principal contract that (directly or indirectly) is contingent upon, or is determined by reference to, any income or gain in respect of an interest in a “specified partnership” (or any other payment the Secretary determines to be substantially similar) 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)), which 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.

Unlike the Ways and Means proposal, the House bill includes a definition of income or gain for these purposes. Specifically, the House bill provides that income or gain includes:

- Any income or gain from the deemed disposition of an interest in a specified partnership as a result of the termination of, or payment with respect to, a specified notional principal contract (determined in the same manner as under section 864(c)(8) but without regard to subparagraph (C) thereof); and
- Any income or gain described in section 871(a)(1) or section 881(a), *i.e.* interest (other than original issue discount), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income.

The proposal would provide exceptions for “Certain Payments” and “Certain Income.” Certain Payments are payments that the Secretary determines does not have the potential for tax avoidance. Certain Income is, under regulations to be prescribed by the Secretary, payments (to the extent determined by reference to income or gain in respect of an interest in a specified partnership) which would be, either exempt from U.S. income tax, or from sources without the U.S. and not effectively connected with the conduct of a U.S. trade or business if earned by a nonresident alien individual or foreign corporation. Accordingly, through future regulations, the proposal would generally only apply to relevant payments determined by reference to U.S. 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 House bill would provide that the Secretary shall issue regulations or other guidance necessary or appropriate to carry out the purposes of the provision, including:

- The application to payments determined under sale-repurchase agreements or securities lending transactions with respect to interests in specified partnerships,
- To determine the amount of a distribution by a specified partnership that is income or gain of the partnership (including the portion thereof that is a Certain Payment or Certain Income) in a manner consistent with proposed section 1441(g), and
- To require the provision of information by specified partnerships necessary to determine such amount.

The proposal would add a new section 1441(g), which would provide that the Secretary may prescribe regulations, under rules similar to section 1446, to determine the amount of a payment in respect of income and gain of a specified partnership that is a dividend equivalent under the proposal.

The House bill proposal would apply to payments made after December 31, 2022, as compared to the proposal in the Ways and Means bill, which applied to payments made after 180 days after the enactment of the provision.

The JCT has estimated that the proposal would raise approximately \$90 million over 10 years.

KPMG observation

- The prior Ways and Means recommendations proposed to apply section 871(m) to sale-repurchase transactions (“repos”) of specified partnership interests, but did not mention securities lending transactions. The House bill proposal would leave the decision whether to apply section 871(m) to repos and securities lending transactions on specified partnerships to Treasury through regulations. The application of section 871(m) to repo transactions 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 securities. 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 exceptions in the proposal with respect to Certain Payments 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 Congress’s 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 or when the transaction is entered into. See Treas. Reg. section 1.871-15(g)(2)(ii). Notably, the proposal would apply to *payments made* after December 31, 2022, rather than *transactions entered into* after December 31, 2022. 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 require the provision of information by PTPs necessary to determine amounts subject to the proposal. 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.
- The House proposal’s extension of the effective date (as compared to the Ways and Means proposal) would hopefully give Treasury time to issue regulations addressing some of the uncertainties and issues described above, and would also give withholding agents and PTPs more time to build systems to comply with the proposal, although likely not enough time.

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 (1) \$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 (2) 10 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 (1) 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 (2) 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 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.

This proposal is substantially identical to a prior Ways and Means proposal. (The House bill proposal retains the same proposed effective date as proposed by Ways and Means.)

The JCT has estimated that this proposal would increase revenue by approximately \$5.72 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 one of the described transaction.

The Ways and Means proposal

The prior Ways and Means proposal would add “digital asset” to the definition of appreciated financial position. A digital asset for these purposes means any digital representation of value that 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.

The House bill

The House bill is similar to the Ways and Means proposal but with a minor modification. It would amend the Ways and Means proposal by expanding the current exception to constructive sale treatment for sales of non-publicly traded property (found in section 1259(c)(2)) by providing that “[a] similar rule shall apply in the case of a contract for sale of any digital asset”. Presumably, this would mean that the exception would be expanded to include a contract for sale of any digital asset that is not a marketable security (as defined in section 453(f)), if the contract settles within one year after the date such contract is entered into. Section 453(b) defines a “marketable security” as any security for which, as of the date of disposition, there was a market on an established securities market or otherwise.

KPMG observation

The prior Ways and Means proposed expansion of the constructive sale rules would 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. The Ways and Means 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 modification contained in the House bill lacks precision. It is not clear, for example, what digital assets would be considered marketable securities within the meaning of section 453(f). Query whether the proposal might be modified to provide greater clarity on what digital assets would be eligible for the section 1259(c)(2) exception from constructive sale treatment.

The House bill 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 wash sale proposal (described below).

Wash sales by related parties; wash sales of specified assets

In general, the current 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. Similar rules apply to short sales.

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, under current law, 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 House bill proposal is similar to the prior Ways and Means proposal, with minor modifications. The proposal would modify the wash sale rules to apply to a loss claimed with respect to any sale or other disposition (including any termination) 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
- Except as otherwise provided by the Secretary, any digital representation of value 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 and notional principal contracts in respect of 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.

Under the proposal, a wash sale could be triggered by acquiring a substantially identical specified asset, entering into a substantially identical specified asset, entering into a contract or option to acquire a substantially identical specified asset, or by entering into a long notional principal contract in respect of a substantially identical specified asset. Similar to current law, analogous rules would apply to short sales.

KPMG observation

Under current law, it is not clear whether certain derivatives, such as notional principal contracts referencing stock or securities, are considered a “contract or option to acquire” stock or securities. The proposal would explicitly make such transactions subject to the wash sale rules. This is one of

the differences between the House bill proposal and the Ways and Means proposal.

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, to the extent the Secretary provides in regulations or other guidance, any individual who bears a relationship to the taxpayer described in section 267(b) if such taxpayer is an individual, 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 proposal would also authorize the Secretary to issue regulations or additional guidance to prevent the avoidance of the wash sale rules through the use of 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 authority for 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 proposal also includes "no inference" language that indicates it should not be construed to create any inference with respect to the proper treatment of related parties under section 1091 prior to the proposal's effective date. This "no inference" language was not included in the Ways and Means proposal.

The application of the wash sale rules across related parties would require adjustments to 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.

Conforming adjustments would be made to other provisions of the Code (e.g., section 6045). However, the proposal would not modify the holding period adjustment rules under section 1223(3) 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 were 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 instruments (which would frequently be specified assets) would not be subject to the wash sale loss disallowance rules. There is no business needs or hedging exception for digital assets. However, it is possible that certain digital assets might also be considered commodities eligible for the exceptions applicable to commodities transactions.

The proposal would apply to sales, dispositions, and terminations occurring after December 31, 2021.

The JCT has estimated that this proposal (together with the proposal dealing with constructive sales) would raise approximately \$16.76 billion over 10 years.

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(a) utilizes the definition in section 1563(a), subject to certain adjustments, for purposes of defining a controlled group of corporations. Section 52(b) provides a similar rule for non-corporate organizations (partnerships, trusts, estates, and sole proprietorships) of trades or businesses.

The House bill would amend section 52(a) and (b).

Section 52(a) would be amended to clarify which entities are included as “component members” of a controlled group. The proposal would provide for general application of these controlled group rules while essentially ignoring the section 1563(b)(2) exclusions (including exclusions for certain foreign corporations, etc.) This modification would be consistent with section 448 and regulations thereunder.

Consistent with the prior Ways and Means proposal, section 52(b) also would be amended 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) defines trade or business to include 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 \$16.8 billion over a 10-

year period.

KPMG observation

The section 52 aggregation rules are cross referenced by many Code provisions and have been frequently incorporated in recent legislation. Notably, the House bill references section 52 for purposes of determining whether a corporation would be subject to the corporate alternative minimum tax proposal.

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” for purposes of determining when commonly controlled activities are aggregated and would generally be disadvantageous.

For example, under the proposal, a private equity fund that owns passthrough or C corporation portfolio companies and that is treated as engaged in a section 212 activity rather than a section 162 trade or business would clearly be included in the determination of whether a “parent-subsidiary group under common control,” “brother-sister group under common control” or “combined group under common control” exists under the section 52 regulations. As a result, under the House bill, to the extent a private equity fund satisfies the more-than-50%-of-the-vote-or-value test with respect to multiple C corporation portfolio companies, such portfolio companies may be aggregated to determine the average annual adjusted financial statement income of each corporation for purposes of determining if they are subject to the corporate alternative minimum tax. In addition, qualification for the small business exemption from section 163(j)(3) for a private equity fund’s portfolio companies (or for a partner who may otherwise be exempt under section 163(j)(3)) may be more difficult under the proposal.

Delay in mandatory capitalization of research and experimentation costs

The TCJA modified section 174 for tax years beginning after December 31, 2021 to subject research and experimentation (R&E) costs to mandatory capitalization. Beginning in 2022, the costs associated with U.S.-based R&E activities would be required to 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. For R&E activities that are conducted outside of the U.S. or a U.S. possession, the applicable amortization period is 15 years. The TCJA also contained a conforming amendment to the definition of “qualified research” in section 41(d)(1)(A).

The House proposal would delay implementation of these TCJA changes by four years. As a result, the required amortization of research and experimental expenditures would begin for amounts paid or incurred in tax years beginning after December 31, 2025 if the proposal were enacted.

The JCT has estimated that the proposal would lose approximately \$4.02 billion over a 10-year period.

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 across 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.

Tax increases for high-income individuals

Application of net investment income tax to trade or business income of certain individuals

Proposed expansion of application of NII tax

Under section 1411, a tax is imposed on net investment income (“NII”) in the case of an individual, estate, or trust. 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 House bill 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, where 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 expands 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 is 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 is specified income reduced by the deductions properly allocable to such income. Specified income is 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 (where all of the above is considered as specified income, regardless of material participation).

Income thresholds and phase-in of increase

The income threshold amount is \$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 is 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 has modified adjusted gross income of, for example, \$540,000, the increase in tax under the proposal is 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 retains the unindexed threshold amounts above which the NII tax applies, 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 does not include wages subject to FICA tax. Second, the proposal would clarify that deductions properly allocable to investment income in determining net investment income do not include net operating loss deductions under section 172. Finally, the proposal would provide that net investment income includes 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 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 has estimated that the proposal would raise approximately \$252.2 billion over 10 years.

KPMG observation

The House bill proposal is substantially similar to the prior Ways and Means proposal, with the exception of the addition of a rule clarifying that net investment income does not include items taken into account in determining self-employment income and a rule that regulations are to be issued to address previously taxed distributions made under section 962(d).

The principal effect of the proposal is 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.

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 Biden Administration's proposal, the

distributive share of materially participating high-income shareholders would have been subject to SECA taxes. Under the present 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.

The proposal is also a departure from the approach adopted in the Biden Administration's Green Book that 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 partner's distributive share of income or loss is excluded. Under the Biden Administration's proposal, the limited partner exception would have only applied in cases where a limited partner was not a high-income taxpayer or did not materially participate in the activity. Under the present 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 that exceeds the stated thresholds noted above, then the taxpayer would be subject to NII on such income, regardless of material participation.

The proposal also does not include the expansive self-employment "donut hole" provision that had been part of President Biden's proposals during his presidential campaign. The donut 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.

The expanded application of the NII tax may enhance the benefits of creating multiple trusts due to the potential for tax savings inherent in splitting income among additional taxpayers and multiplying available thresholds. However, multiple trusts may be treated as a single trust in certain circumstances so consideration should also be given to the limitations in section 643(f). Given the lower threshold for trusts and estates to be subject to the NII tax, it may become increasingly important for trustees to consider making distributions to beneficiaries who would not be subject to the NII tax 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.

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.

Consistent with the Ways and Means proposal, the House bill proposes to 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 House bill proposes to add a rule that if, upon the termination of an estate or trust, the estate or trust has an excess business loss carryover, that carryover will be allowed to the beneficiaries succeeding to the property of the estate or trust in accordance with regulations.

Consistent with the Ways and Means proposal, the limitation on excess farm losses under section 461(j) would also be repealed under this proposal.

If enacted in its current form, this proposal would apply for tax years beginning after December 31, 2020.

The JCT has estimated this proposal would increase revenue by approximately \$160.3 billion over a 10-year period.

KPMG observation

The proposal would represent a substantial change to the manner in which the excess business loss regime currently operates. By modifying the provision to have excess business losses “re-tested” in the taxpayer’s subsequent tax year—as compared to treating as an NOL in the following year—a taxpayer’s ability to claim trade or business deductions could be significantly limited.

Net operating loss deductions for tax years beginning after December 31, 2020 are limited to 80% of taxable income and can generally offset any type of income. In contrast, if the loss is required to be re-tested, it may take many more years for the taxpayer to be able to utilize the benefit of such losses. Further, if a taxpayer might have consecutive years of excess business losses, the proposed modification may significantly compound the delay in utilization of such losses.

KPMG observation

If enacted, 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 House bill is substantially similar to the prior Ways and Means proposal with the exception of the addition of a new rule addressing excess business loss for a terminating trust or estate. This new rule seems to represent an acknowledgement that losses disallowed under section 461(l) would otherwise simply disappear when a taxpayer ceases to exist (such as upon the death of an

individual).

KPMG observation

The House bill proposes a retroactive effective date for this provision of 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, estates, and trusts

Currently, there is no separate income tax surcharge levied on individuals, estates, or trusts with income above certain levels.

Proposal

The proposal would impose a new 5% income tax surcharge on individuals, estates, and non-grantor 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 \$10 million for taxpayers who file as single, head of household, or married filing jointly, \$5 million for taxpayers who file married filing separately, and \$200,000 for estates and trusts. An additional 3% income tax would be imposed on MAGI in excess of \$25 million for taxpayers who file as single, head of household, or married filing jointly, \$12.5 million for taxpayers who filed married filing separately, and \$500,000 for estates and trusts.

For purposes of these proposed surcharges, a taxpayer's MAGI would be AGI reduced by any deduction (other than "above-the-line" deductions considered in determining AGI) allowed for investment interest or business interest. Estates and trusts would be subject to the 5% surcharge once their MAGI exceeds \$200,000, and would be subject to the additional 3% surcharge on MAGI over \$500,000. MAGI for this purpose would be adjusted gross income (AGI) reduced by (1) deductions for expenses specific to trusts or estates, (2) the income distribution deductions, (3) the personal exemption, and (4) deductions for charitable contributions.

Nonresident aliens would be subject to the income tax surcharges only on income that is effectively connected with the conduct of a trade or business within the United States, less any deductions allocable to such 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 surcharges.

Under the proposal, the income tax surcharges would not be considered in determining the amount of any income tax credit other than the foreign tax credit, or in determining the amount of any credit for AMT purposes.

The proposal would amend the rules applicable to “boomerang” aliens under Code sections 877(b) and 7701(b)(10) with the result that the surtax could apply to such individuals. “Boomerang” aliens are certain foreign individuals who are U.S. residents for at least three consecutive years, who then cease to be U.S. residents, and who then become U.S. residents again before the close of the third calendar year starting after their residency termination date in relation to the initial residency period. Such individuals are subject to tax under a special expanded definition of U.S. source income during the interim nonresidency period. Thus, under the proposal, if a boomerang alien realized a significant amount of gain from the sale of U.S. source assets during the interim nonresidency period, the gain could be subject to the surtax if the applicable thresholds are met.

A U.S. shareholder of a passive foreign investment company (PFIC) may be subject to a special tax calculation that is determined by taking into account the highest rate of tax in effect for a tax year(s). Under the proposal, the highest rate of tax in effect would be equal to the sum of the highest rate in effect for the applicable tax year(s) under section 1 plus the surcharges.

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

The JCT estimates this proposal would increase revenue by approximately \$227.8 billion over the 10-year budget window.

KPMG observation

A U.S. shareholder of a controlled foreign corporation (CFC) must include certain amounts into income currently for the tax year. An individual U.S. shareholder may elect to compute U.S. tax on the income inclusion as though the individual were a domestic corporation. The proposal would allow an individual U.S. shareholder of a CFC to determine their tax on the income inclusion under the corporate tax regime without being subject to the new surcharges.

KPMG observation

Trusts with beneficiaries who have income less than the individual surcharge tax threshold may be able to reduce the effective tax rate on the trust income by distributing it to the beneficiary. Assume a trust has \$4M in taxable income and a trust beneficiary has \$1M in taxable income before trust distributions. If the trust were to make no distributions for the year, it would be subject to a surcharge tax of \$295,000. If, instead, the trust makes a distribution of \$4M to the beneficiary, the beneficiary would still have total taxable income below the individual threshold for the surcharge tax and neither the trust nor the beneficiary would pay the surcharge tax. Of course, there may be transfer tax or non-tax considerations that prevent the trust from making the distribution or make such a distribution undesirable.

KPMG observation

This proposal could create a cash flow complication for passthrough entities. Many partnerships and S corporations distribute cash proportionately to the owners of the entity to pay taxes, and the formula for such distributions is often based on the highest marginal federal and state tax rates applicable for the owners of the entity. Even if the majority of a partnership’s partners or S corporation’s shareholders are below the surcharge threshold amounts, if a partnership or S

corporation has one or more trusts or estates subject to this proposed additional 8% tax (as a result of the reduced surcharge threshold amounts for trusts and estates), the passthrough entity might be required to distribute out an additional 8% (or even 11.8% with increased application of NIIT) to all shareholders, potentially creating a pressure point on cash flow for the passthrough entity.

KPMG observation

The Tax Reform Act of 1986 introduced compressed income tax brackets for non-grantor trusts and estates which had previously been taxed at the individual, married filing separately, tax rates. As a result, the current top income tax bracket of 37% is reached in 2021 at just \$13,050 of taxable income for a trust or estate while a single individual would not reach that bracket until their taxable income exceeded \$523,601. This significantly reduces the incentive to create trusts as a mechanism to split income and reduce tax liability. However, the implementation of the surtax may change that. For example, a trust with \$1 million of taxable income would pay approximately \$55,000 in surcharge tax. If the same assets were held equally by two trusts, the trusts would only pay a combined \$30,000 in surcharge tax, saving approximately \$25,000 each year. As a result, it may be increasingly beneficial to create multiple non-grantor trusts. However, multiple trusts may be treated as a single trust in certain circumstances so consideration should also be given to the limitations in section 643(f).

KPMG observation

The proposed surcharge provision would also make two changes to section 6225, which relates to the calculation of a partnership's imputed underpayment under the Centralized Partnership Audit Regime. Section 6225(b)(1), which prescribes the tax rate to which adjustments are subjected in computing an imputed underpayment, currently provides that the netted partnership adjustments are multiplied by the highest rate in effect under section 1 or section 11. The proposal would amend this section to treat the highest rate of tax in effect under section 1 as being equal to the sum of such rate and the rates in effect under the surcharge provision. For example, if the highest effective rate under section 1 were 37%, then the provision would treat the highest rate as being 37%, *plus* 3%, *plus* 5%, for a total of 45%.

Section 6225(c)(4) generally allows a partnership to reduce the imputed underpayment to the extent that the partnership can demonstrate that a portion of an adjustment is allocable to a partner that is subject to a lower tax rate. The new proposal would allow a partnership to apply a lower tax rate to the extent an adjustment is allocable to a partner that is not an individual subject to one or both of the surcharge rates.

Taken together, these two amendments to section 6225 would result in effectively applying, as a default, the highest individual tax rate, including the highest surcharge rate, in calculating a partnership's imputed underpayment, unless, and only to the extent that, the partnership can demonstrate that its partners are not subject to the surcharge. As a practical matter, it may prove difficult for a partnership to obtain this information, particularly where the partnership would need to look through multiple tiers to identify the ultimate individual partners. The higher rate, combined with potential challenges in demonstrating the surcharge rate should not apply, may result in partnerships being more likely to push out adjustments to their partners rather than paying at the partnership level.

Modifications of rules relating to retirement plans

Contribution limit for individual retirement plans of high-income taxpayers with large account balances

The House bill 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 increase attributable to minimum required distributions (as amended by the proposal).

The proposal would apply to an “applicable retirement plan,” which includes a defined contribution plan under section 401(a) or section 403(a), an annuity under section 403(b), a deferred compensation under section 457(b) maintained by a State or agency or instrumentality or political subdivision of a State, or an individual retirement plan. Both the account limit and the income amounts would be subject to cost-of-living adjustment after 2029.

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 an excise tax would apply if a prohibited annual addition were made to an IRA.

There is proposed to be a new information reporting requirement for high account balances. If at the end of any plan year, one 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 with the IRS which includes the name and identifying number of the participant and the amount to which the participant is entitled. The vested account balance amount subject to this reporting requirement would be adjusted for inflation after 2029.

These changes are proposed to apply to tax years beginning after December 31, 2028. The information reporting would apply to plan years beginning after December 31, 2028.

The JCT estimate of the revenue impact of this proposal has been combined with the JCT estimate for the proposal below.

Increase in minimum required distributions for high-income taxpayers with large retirement account balances

The House bill 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:

- 1) The sum of
 - a) The “applicable Roth excess amount” (the lesser of (a) Roth amounts or (b) amounts in excess of \$20 million, indexed) plus
 - b) 50% of the aggregate vested retirement plan balance that exceeds \$10 million (indexed) reduced by the applicable Roth excess amount over
- 2) 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, such required distributions would not be eligible for rollover distribution treatment.

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

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

These provisions are proposed to be effective for tax years and plan years beginning after December 31, 2028.

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 \$7.3 billion over the 10-year budget window.

KPMG observation

There has been much publicity recently regarding “MEGA IRAs.” Thus, the inclusion of various proposals focused upon a variety of limits imposed on both contributions and required distributions is not surprising. The House bill proposals on contributions and required distributions is similar to the Ways and Means proposals but would extend the proposed effective date until after 2028. Due to the \$10 million threshold, the contribution and distribution requirements would not likely affect the majority of retirement plan participants.

KPMG observation

Note that the Ways and Means proposals restricting the holding of certain investments in IRAs have been removed from the House bill.

Tax treatment of rollovers to Roth IRAs and accounts

The House bill would eliminate a conversion from a traditional pre-tax IRA to a Roth IRA for any taxpayer

with adjusted taxable income that exceeds \$450,00 for a joint return, \$400,000 for an individual return, or \$425,000 for head of household.

Further, the same individuals would be unable to convert amounts held in pre-tax non-Roth defined contributions plans, such as 401(k) plans, 403(b) arrangements, and governmental section 457(b) plans, to a designated Roth account. This part of the proposal would apply to distributions, transfers, and contributions made in tax years beginning after December 31, 2021.

The House bill 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 designated 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 \$2.7 billion 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. The House bill would eliminate the use of the “back door” conversion starting in 2022 for all individuals regardless of income. This proposal would affect many more individuals than the contribution and distribution provisions for the large retirement account balance proposals. The House bill is substantially identical to the Ways and Means proposal.

Statute of limitations with respect to IRA noncompliance

The House bill is substantially identical to the Ways and Means proposal and 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 \$7 million over the 10-year budget window.

IRA owners treated as disqualified persons for purposes of prohibited transaction rules

While an IRA is generally exempt from taxation, an IRA can lose its IRA tax status 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 House bill 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 House bill, which is substantially identical to the Ways and Means 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.

[Prohibited transactions relating to holding DISC or FSC in individual retirement account](#)

The U.S. tax system has had a series of special tax regimes intended to provide incentives for foreign trade, including domestic international sales corporations (DISC) and foreign sales corporations (FSC). The House bill 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.

Funding the IRS and improving taxpayer compliance

Funding the IRS

The House bill proposal would provide \$79.6 billion in additional funding to the IRS, including \$1.9 billion for taxpayer services, \$44.9 billion for enforcement, \$27.4 for operations support, and \$4.85 for business systems modernization. The additional funding would be over the 10-year budget window commencing with fiscal year 2022 until fiscal year ending September 30, 2031 and would be in addition to other funding otherwise available to the IRS. The proposal includes a provision stating that nothing in the proposal is intended to increase taxes on taxpayers with taxable income below \$400,000. A similar appropriation was proposed in the version of this legislation that was approved by the Ways and Means Committee on September 15, 2021.

According to the JCT Technical Explanation of the similar proposal approved by the Ways and Means Committee, the fiscal year 2021 congressional appropriation for the IRS was \$11.9 billion. The JCT indicated that this fiscal year 2021 appropriation 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.

While the House bill proposal is similar to the Ways and Means proposal in the overall amount of funding for the IRS, the House bill is more detailed in that it proposes to designate certain amounts for specific purposes. The additional IRS funding proposed by the House bill would designate the uses of those appropriations as follows:

- \$1.9 billion for taxpayer services, including pre-filing assistance and education, filing and account services, and taxpayer advocacy services
- \$44.9 billion for tax enforcement activities, including determining and collecting taxes, providing legal and litigation support, conducting criminal investigations, providing digital asset monitoring and compliance activities, enforcing criminal statutes for violations of internal revenue laws and other financial crimes
- \$27.4 billion for necessary expenses to support taxpayer service and enforcement programs, including facilities services; headquarters and other IRS-wide administration activities; telecommunications; and information technology development, enhancement, operations, maintenance, and security
- \$4.75 billion in additional funding would provide for business systems modernization, including development of callback technology and other technology to provide a more personalized customer service

The proposal would mandate that no later than six months after the date of enactment, the IRS Commissioner submit to Congress a plan detailing how such funds will be spent over the 10-year period ending with fiscal year 2031. The proposal would also require the Commissioner to report on a quarterly basis any updates to the plan, progress made on implementing the plan, and any change in circumstances or challenges in implementing the plan. In the case of a failure to submit the plan or a quarterly report within 60 days of the required submission date, IRS funding would be reduced by \$100,000 for each day the failure continues.

The proposal would allow the Treasury Secretary (or the Secretary's delegate) to use the funds made available for the IRS to take such personnel actions as the Secretary determines necessary to administer

the Code. Under the proposal, such actions would include:

- 1) Utilizing direct hire authority to recruit and appoint qualified applicants, without regard to any notice or preference requirements, directly to positions in the competitive service,
- 2) Appointing not more than 200 individuals under streamlined critical pay authority to positions critical to taxpayer services, tax enforcement activities, or IRS operations support, and
- 3) Appointing, without approval of the Office of Personnel Management, not more than 300 individuals to critical pay positions for which the rate of basic pay may not exceed the salary set in accordance with 3 U.S.C. section 104 and the total annual compensation may not exceed the maximum amount of total annual compensation payable at the salary set in accordance with 3 U.S.C. section 104.

The proposal also would designate \$15 million of additional funding related to designing an IRS-run free “Direct Efile” tax return system. The proposal would require the IRS to deliver to Congress within nine months of the date of enactment a report detailing

- 1) The cost (including options for differential coverage based on taxpayer adjusted gross income and return complexity) of developing and running a free direct efile tax return system, including costs to build and administer each release, with a focus on multi-lingual and mobile-friendly features and safeguards for taxpayer data;
- 2) Taxpayer opinions, expectations, and level of trust, based on surveys, for such a free direct efile system; and
- 3) The opinions of an independent third-party on the overall feasibility, approach, schedule, cost, organizational design, and IRS capacity to deliver such a direct efile tax return system.

In addition to funding for the IRS, the proposal would provide:

- \$403 million to the Treasury Inspector General for Tax Administration for necessary expenses in carrying out the Inspector General Act of 1978,
- \$104.5 million to the Treasury Department Office of Tax Policy for necessary expenses to carry out functions related to promulgating regulations under the Code of 1986, and
- \$153 million to the U.S. Tax Court for necessary expenses.

These appropriations would be effective upon enactment.

Estimates of the revenue impact of this proposal will be provided by the CBO.

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 House bill proposal differs from the Ways and Means proposal in several significant ways. In particular, the House bill proposes to:

- Give the IRS direct hire and critical pay authority,
- Appropriate \$15 million related to an IRS “direct efile” tax return system and require the IRS to submit a report on the viability of such a system within nine months of the date of enactment,

- Require the Commissioner to provide an initial plan and quarterly update reports (through the end of fiscal year 2031) on how IRS funds will be spent over the 10-year spending period and would impose a \$100,000 sanction for failure to provide such plan or reports by the required date, and
- Appropriate funds for the Treasury Department Office of Tax Policy to use toward promulgating regulations under the Code.

KPMG observation

The CBO has not published an analysis of the estimated budgetary effects for this proposal as of the date of this publication. While many proponents of the proposal assert that investments in IRS enforcement are likely to produce government revenue increases far in excess of the initial IRS appropriations, it is possible that the CBO analysis of the amount of potential revenue may differ.

Of interest, on September 2, 2021, CBO estimated that portions of the administration's proposal to increase funding for the IRS by \$80 billion over the 2022–2031 period would increase revenues by approximately \$200 billion over those 10 years. CBO indicated that the estimate relied upon the IRS's projected returns on investment (ROIs) for spending on new enforcement initiatives. 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. See Publication 57444, *The Effects of Increased Funding for the IRS*, Congressional Budget Office (Sept. 2, 2021).

Application of backup withholding with respect to third party networking transactions

The House bill proposes to add section 3406(b)(8), which would expand the scope of payments made in settlement of third-party network transactions that can trigger backup withholding. Specifically, the House bill proposal would provide that a reportable payment that may trigger a backup withholding requirement would include any payment in settlement of a third-party network transaction where 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.

The proposal would also make a coordinating change to section 6050W to change the *de minimis* threshold from "exceeds \$600" to "equals or exceeds \$600," consistent with the proposed change to 3406(b)(8).

This new section is proposed to apply to calendar years beginning after December 31, 2021. However, the proposal includes a transition rule for 2022 which would provide that backup withholding for TPSOs that exceed the \$600 *de minimis* threshold applies 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 as a result of the enactment of the American Rescue Plan Act (ARPA) in March 2021. Under current law, TPSOs are only required to report for section 6050W purposes, and backup withholding can only be triggered, 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 to law 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, post calendar year 2022, the *de minimis* rules for reporting and backup withholding under section 6050W would be consistent if the proposal were enacted.

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.

The House proposal is identical to a previous Ways & Means proposal.

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 any penalty under the Code, Section 7491(c) provides that, in the case of any individual, the IRS has the burden of *production* with respect to any penalty, addition to tax, or additional amount imposed by Title 26. In other words, the IRS has the burden to present sufficient evidence showing that it is appropriate to impose the relevant penalty before the burden of proof shifts to the taxpayer. Case law has established that the IRS’s compliance with procedural requirements is an essential part of its burden of production. Therefore, the IRS must produce evidence of compliance with the supervisory approval requirement to satisfy Section 7491(c).

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 of the prior Ways and Means proposal asserts that these court decisions have led to uncertainty regarding the application of section 6751(b). As described by that 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 House bill proposal is substantially identical to the Ways and Means proposal. The House bill proposes to repeal the requirement for prior supervisory approval of penalties before assessment by the IRS set forth in current law section 6751(b).

The repeal would be 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 comply with the statutory requirements of section 6751(a) and administrative policies intended to ensure voluntary compliance.

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 requirement, the proposal appears to undercut that original purpose.

Infrastructure financing and community development

The House bill does not include any of the Ways and Means proposals that would have enhanced and expanded the rehabilitation tax credit.

KPMG observation

The House bill does not include any of the Ways and Means proposals, including temporarily increasing the HTC percentage and eliminating HTC basis reduction which would have increased the depreciable basis of the building. Also, the House bill did not include the Ways and Means proposal that would have eliminated the requirement that lessees include in income an amount equal to 100% of the HTC ratably over recovery life of the building.

According to the Ways and Means Committee summary, the Ways and Means proposal that

limited the application of the disqualified lease rules to government entities, would have made HTCs easier to access by non-profits and other tax-exempt entities and make projects like health care centers, arts organizations, community services, workforce training providers, and others better able to use the HTC.

The removal of these proposals is significant given the fact that the 2017 U.S. tax law, commonly referred to as the “Tax Cuts and Jobs Act” (TCJA) (Pub. L. No. 115-97) amended the HTC so that the credit is taken over five years instead of all in one year. The Ways and Means proposals would have restored some of the incentive value of the credit that was reduced in the TCJA change.

Low-income housing credit

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

KPMG observation

The House bill does not include several LIHTC proposals that were included in the Ways and Means proposal. These provisions include a proposal to allow states the ability to provide an enhanced credit of up to 130% for projects in rural areas and a proposal that would have allowed state housing agencies to designate certain buildings financed with the proceeds of tax-exempt bonds as being located in difficult development areas.

KPMG observation

While the House bill does not include some of the Ways and Means proposals and generally reduces some of the benefits of others, as discussed below, the House bill proposals still would be a significant expansion of the LIHTC by increasing the amount of the credit available to support and expand affordable housing. The proposals also would provide enhanced credits that specifically target and encourage more affordable housing for certain groups or areas such as extremely low-income households and Indian tribes. (See further discussion below in investments in tribal infrastructure discussion.) The proposals 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 albeit until 2026 instead of the 2028 Ways and Means proposal. In addition, the House bill proposal to repeal the qualified contract option proposal would preserve the affordability housing rather than allowing a process for the project to become market rate at the end of the compliance period.

Increase in state housing credit ceilings

The House bill would limit housing credit ceiling increases through 2025 and would modify the housing credit ceiling amounts so that:

- For 2022, the population component of the state housing credit ceiling would be equal the greater of (1) \$3.14 multiplied by the state population, or (2) \$3,629,096;
- For 2023, the population component of the State housing credit ceiling would equal the greater of (1) \$3.54 multiplied by the state population, or (2) \$4,081,825;

- For 2024, the population component of the State housing credit ceiling would be equal to the greater of (1) \$3.97 multiplied by the state population, or (2) \$4,582,053; and,
- For 2025, the population component of the state housing credit ceiling would be equal to the greater of (1) \$2.65 multiplied by the state population, or (2) \$3,120,000.

These amounts are adjusted for inflation.

The House bill is similar to the prior Ways and Means proposal with some modifications.

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

The JCT has estimated that the proposal would lose approximately \$2.08 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.

More specifically, 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, the 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 House bill proposal would modify the special rule for buildings financed by tax-exempt bonds by lowering the percent limitation from 50% to 25% for buildings the aggregate basis of which (and the land on which the building is located) is financed by certain tax-exempt obligations issued in calendar year 2022, 2023, 2024, 2025, or 2026.

The proposal would be effective for buildings some portion of which, or of the land on which the building is located, is financed by an obligation which is described in section 42(h)(4)(A) and which is part of an issues the issue date of which is after December 31, 2021.

The JCT has estimated that the proposal would lose approximately \$8.6 billion over a 10-year period.

KPMG observation

The House bill is similar to the prior Ways and Means proposal but would temporarily reduce the 50% requirement to 25% for buildings financed by the proceeds of tax-exempt bonds issued in any calendar year 2022-2026. The Ways and Means proposal would have extended the 25% reduction until 2028 (and not by any obligation taken into account during any tax year beginning in 2019-2021).

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.

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.

Buildings designated to serve extremely low-income households

The House bill would require that at least 8% of the state housing credit ceiling be allocated to certain buildings with extremely low incomes. Also, no more than 13% of a state's housing credit ceiling could be used for an enhanced low-income housing tax credit of up to 150% of a low-income building's portion of its eligible basis comprised of extremely low-income units. In the case of projects financed by tax-exempt bonds, a state may not issue more than 8% of the private activity bond volume cap for the enhanced credit.

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 line (within the meaning of section 36B(d)(3)).

The House bill would make 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 portion of its eligible basis which is comprised of extremely low-income household units would be increased to 150% of the otherwise applicable eligible basis.

The House bill is similar to the Ways and Means proposal with certain modifications.

The enhanced credit would be available for allocations made after December 31, 2021, and for bond financed buildings only obligations that are part of an issue the issue date of which is after December 31, 2021.

The JCT has estimated that the proposal would lose approximately \$2.03 billion over a 10-year period.

Repeal of qualified contract option

The House bill proposal is substantially identical to the prior Ways and Means proposal to repeal the qualified contract option.

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 House bill 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 \$457 million over a 10-year period.

Modification and clarification of rights relating to building purchase

Currently, no federal income tax benefit fails 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 House bill 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.

KPMG observation

The House bill is similar to the Ways and Means proposal. It does not, however, include the Ways and Means proposal that 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).

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 \$ 553 million over a 10-year period.

Neighborhood homes investment tax credit

The House bill proposal is substantially identical to the Ways and Means proposal to create a new general business credit for (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 \$3 multiplied by the state population, or \$4,000,000 (\$8,000,000 in the case of calendar year 2025), plus certain plus certain previously allocated credits. This amount would be indexed for inflation for years after 2022.

Responsibilities of NHCAs

Sponsors seeking potential NHCs would apply on a competitive basis by providing candidate plans for construction or rehabilitation to the NHCAs. Each NHCA would establish a qualified allocation plan (QAP) to guide it in allocating potential NHCs among competing proposals. The NHCA would also be responsible for promulgating certain standards, monitoring compliance with all provisions governing NHCs, 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 \$5.86 billion over a 10-year period.

KPMG observation

The House bill proposal is substantially identical to the Ways and Means proposal to 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. However, the House bill proposal would reduce the amount of NHCA credit ceiling available to support NHC allocations provided under the Ways and Means proposal by half for 2022-2024.

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 with regard to 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 House bill proposal (which is the same as the prior Ways and Means 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 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 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)) do 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 is no volume cap for governmental bonds issued by an Indian tribal government.

The proposal includes a special rule for situations where 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 shall have the rights and responsibilities of the authorizing Indian tribal government only to the extent provided in the authorizing resolution.

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

The JCT has estimated that the proposal would lose approximately \$77 million over a 10-year period.

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. These new rules would not repeal the Tribal Economic Development Bonds.

New markets tax credit for tribal statistical areas

The House bill proposal is similar to the Ways and Means proposal to provide an annual \$175 million NMTC allocation for low-income communities in Tribal Statistical areas for 2022-2025 instead of in calendar years after 2021 under the Ways and Means proposal.

A tribal statistical area is any low-income community which is located in any Tribal Census Tract, Oklahoma Tribal Statistical Area, Tribal- Designated Statistical Area, Alaska Native Village Statistical Area, or Hawaiian Home Land, including a low-income community business that services a significant population of Tribal or Alaska Native Village members residents.

The proposed amendment would be effective for NMTCs determined for calendar years after December 31, 2021.

JCT has estimated that the proposal would lose approximately \$178 million over a 10-year period.

KPMG observation

The House bill does not include the Ways and Means proposals that would have made the NMTC (NMTC) permanent; provided for additional NMTC allocations for 2022-2023; allowed the NMTC to offset the alternative minimum tax (AMT); and provide an annual \$100 million NMTC allocation for low-income communities in U.S. territories.

Increasing the NMTC allocation authority for tribal statistical areas would drive more investment in such areas and allow qualified businesses in tribal statistical areas greater participation in the NMTC program.

Inclusion of Indian areas as difficult development areas for LIHTC

The House bill is substantially identical to the Ways and Means proposal to modify the definition of a difficult development area to 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 would be 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 \$117 million over a 10-year period.

Other provisions

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

For a Qualified Small Domestic Corporation (QSDC), the credit could increase to 50% of the sum of the qualified possession wages and allocable employee fringe benefit expenses paid or incurred for the tax year up to \$142,800 with respect to each full-time employee. A QSDC is a qualified domestic corporation with at least five full-time employees located in a possession and no more than a total of 30 employees and no more than \$50 million in annual gross receipts.

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.

The proposal contains minor modifications related to the QSDC credit when compared with the Ways and Means bill.

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.

Tax treatment of certain assistance to farmers, etc.

The House bill includes a provision addressing the tax treatment of certain payments made by the Secretary of Agriculture to socially disadvantaged farmers, ranchers, forest land owners and operations, and groups under the ARPA. In general, the payments would be excluded from the gross income of the recipients and the existence of the payments should not impact deductions, basis or other tax attributes by reason of such exclusion.

The provision was not included in the Ways and Means proposal.

If enacted, the provision would be effective as if it were included in ARPA.

An estimate of the budgetary impact of the proposal will be provided by the Congressional Budget Office.

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

The proposal would provide an exclusion from gross income for amounts received by individuals as a qualified catastrophe mitigation payment from grant programs established by states (or their political subdivisions) related to earthquakes, fires, windstorms, and other disasters.

The proposal is substantially like a provision in the Ways and Means bill.

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

The JCT estimated that the provision would decrease revenues by approximately \$126 million over 10 years.

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 of 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 for projects placed in service after 2021. Projects could continue to elect the ITC instead of the PTC as under current law.

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. If the failure to pay prevailing wages is due to intentional disregard, the taxpayer must pay three times the pay differential to laborers and pay a \$10,000 penalty per worker within 180 days of the date of determination of noncompliance.

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 10% for projects for which construction begins in 2022. This rate would be increased to 12.5% in 2023, and 15% thereafter. In the event a taxpayer fails to satisfy these requirements, the taxpayer may cure the failure by paying a \$50 penalty for each labor hour for which the requirement is not satisfied (\$500 if the government determines that the failure to follow the requirement was due to intentional disregard). There is also an exemption process in the event there is a lack of available qualified apprentices.

Projects that

- 1) commenced construction no later than 60 days after the date that the government issues prevailing wage or apprenticeship guidance or
- 2) have a maximum net output of less than one megawatt

would be treated as eligible for the bonus rate.

The proposal also would make solar energy facilities eligible for the PTC.

The proposal would make 100% of the (base and bonus) PTC credit rate available for facilities that commence construction by the end of 2026.

A new emission-based production tax credit would apply to projects that begin construction after 2026. See discussion below.

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.

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 an applicable percentage of the total cost of the components of such product is attributable to components that are mined, produced, or manufactured in the United States. The applicable percentage is:

- 1) 40% for projects that begin construction prior to 2025
- 2) 45% for projects that begin construction in 2025
- 3) 50% for projects that begin construction in 2026
- 4) 55% for projects that begin construction after 2026

Such rules are to be applied in a manner consistent with the United States' obligations under international rules. The applicable percentage for offshore wind would be phased in at a lower percentage, fully phasing in at 55% in 2028.

If a project is financed with tax-exempt bonds, the amount of the PTC is reduced by the lesser of: (i) 15%, or (ii) a fraction, the numerator of which is the total capital expenditures financed with tax-exempt bonds and the denominator is the total capital expenditures.

Proposed ITC modifications

The proposal would extend the ITC, which allows taxpayers to claim a tax credit for the cost of qualified energy property.

For solar, fuel cell, microturbines, and small wind, the ITC would be extended to projects that begin construction prior to 2027. For geothermal heat pumps, combined heat and power system property, and waste energy recovery property, the credit would be extended to projects that begin construction prior to 2034.

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. For geothermal heat pumps, combined heat and power systems and waste energy recovery property, 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.

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. If the failure to pay prevailing wages is due to intentional disregard, the taxpayer must pay three times the pay differential to laborers and pay a \$10,000 penalty per worker within 180 days of the date of determination of noncompliance.

The apprenticeship requirements are the same as under the PTC proposal.

Projects that:

- 1) Commence construction no later than 60 days after the date the government issues prevailing wage and apprenticeship guidance or
- 2) 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. The domestic content requirements are the same as under the PTC proposal.

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 if construction begins prior to 2027. 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, interconnection property and biogas property.

A rule similar to that for the PTC proposal applies to projects financed with tax-exempt bonds.

A new emission-based investment tax credit would apply to projects that begin construction after 2026. See discussion below.

The proposal would apply to facilities placed into service after December 31, 2021. The amendments pertaining to newly eligible property would also apply to property placed in service after 2021 but for property the construction of which begins prior to 2022, only to the extent of the basis attributable to the construction, reconstruction, or erection after 2021.

The JCT estimates that the above proposals would decrease revenues by \$106.97 billion over 10 years.

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 will 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.

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 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 and wind facilities placed in service in connection with low-income communities

The proposal would add a provision for an enhanced ITC for solar and wind 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, community-based organizations, an Indian tribal government or Alaska Native Corporation.

The annual capacity limitation is 1.8 gigawatts for each calendar year 2022 through 2026 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 2026. 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 take effect January 1, 2022.

The JCT estimate of revenue impact is included in the estimate for the prior section.

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 House bill 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 45W zero-emission nuclear production tax credit
- Section 45X clean hydrogen production credit
- Section 48E zero emissions facility credit
- Section 45AA advanced manufacturing production credit
- Section 45BB clean electricity production credit
- Section 48F clean electricity investment credit
- Section 45CC clean fuel production credit

This proposal is similar to a Ways and Means proposal but with minor modifications. The proposal provides that taxpayers electing this treatment under sections 45, 45Q, 45X, and 45BB must make a one-time, irrevocable election to have the section apply during the tax year the facility is placed into service.

For the credits under sections 48, 45, and 48D, the proposal would impose a phasedown of the direct pay amount contingent on meeting the 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 commence construction in 2025, and 0 for projects that commence construction in 2026 and later. 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, the Tennessee Valley Authority, Indian tribal governments, or an Alaskan native corporation, would be treated as taxpayers eligible to elect a direct payment.

In the case of a partnership or S corporation, elections and direct payments would be made at the partnership or S corporation level. The proposal would make some special rules applicable to partnerships, and S corporations. For instance, the proposal states that direct payment amounts would

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 270 days after date of enactment.

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

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 some 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.

In addition, it is noteworthy that the proposal provides that any refund of taxes attributable to a direct pay election would not increase adjusted financial statement income for purposes of the corporate minimum tax.

Investment credit for electric transmission property

The House bill provides for 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 of 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.

The bonus rate would be available to all projects on which construction begins prior to 60 days after that date guidance is issued on the prevailing wage and apprenticeship requirements

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;
- A superconducting line, defined as a transmission line that conducts all of its current over superconducting material; 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.

Upgrades to an existing electric transmission line are treated as replacement lines and eligible for the credit.

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 language specifies that for purposes of section 48D, construction on property begins when the taxpayer has begun on-site physical work of a significant nature with respect to such property. The proposed credit would be effective for property placed in service after December 31, 2021 and would sunset December 31, 2031.

The JCT has estimated that the proposal would lose approximately \$11.3 billion over a 10-year period.

KPMG observation

Section 48D as proposed in the House bill is substantially similar to the provision in the Ways and

Means proposal, with a few modifications. Among the modifications to the Ways and Means proposal is an expansion of definition of eligible property to include superconducting lines.

It is also interesting to note that the House bill specifies that the only way to establish the beginning of construction is through “physical work of a significant nature.” Existing IRS guidance on the beginning of construction for other energy credits also allows the beginning of construction to be established by beginning physical work or incurring a percentage of project costs. This may mean that projects for which costs have been incurred prior to January 1, 2022, but on which physical work has not begun, could be eligible.

Finally, the ITC is subject to the normalization rules which can impact the value of the incentive for regulated utilities as compared to non-regulated entities. Similar to the Ways and Means proposal, the House bill proposal does not include a normalization opt out for this credit. 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.

Extension of credit for carbon oxide sequestration

The House bill proposes to extend and modify the credit for carbon oxide sequestration facilities. The House bill proposal is similar to a Ways and Means proposal, but with significant modifications.

Current law section 45Q allows credits to taxpayers who capture and sequester qualifying carbon oxide. The amount of the credit depends on how the captured 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 would modify the minimum capture thresholds under section 45Q. To qualify for the credit under the proposal, 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.

The proposal would provide a base credit rate of \$17 and a bonus credit rate of \$85 per metric ton of carbon oxide captured for geological storage and a base credit rate of \$12 and a bonus credit rate of \$60 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

secure geological storage and a base rate of \$26 and a bonus rate of \$130 per metric ton of carbon captured and utilized for an otherwise 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 any alteration or repair during the 12-year credit period, and
- 2) Apprenticeship requirements during the construction, alteration, or repair of the project.

Projects that commence construction before the date that is 60 days after the Secretary publishes guidance with respect to these requirements would be treated as eligible for the bonus rate for any carbon oxide captured and disposed of after December 31, 2021.

In addition, in the case of a qualified facility the construction of which begins before January 1, 2022, the proposal would provide these credit rates for the incremental increase in the amount of qualified carbon oxide captured with additional carbon capture equipment installed at a qualified facility if construction of the carbon capture equipment begins after December 31, 2021.

The proposal would provide for a reduction of the credit in the case of projects financed with tax exempt bonds, which begin construction after December 31, 2021.

The proposal would sunset the prior section 45Q credit related to carbon capture equipment placed in service before February 9, 2018 at the earlier of January 1, 2023, or the end of the calendar year when the Secretary, in consultation with the Administrator of the Environmental Protection Agency, certifies that a total of 75 million metric tons of qualified carbon oxide have been taken into account.

The proposal would allow an election to have the 12-year credit period begin on the first day of the first tax year in which the credit is claimed if the carbon capture equipment is placed in service after February 9, 2018, no taxpayer has claimed the credit with respect to such carbon capture equipment for any prior tax year, the qualified facility is in a federally-declared disaster area, and the disaster results in a cessation of the operation of the facility after the original placed in service date.

Notably, under the proposal, the section 45Q credit would be refundable under a direct pay election. Taxpayers must make an irrevocable election separately with respect to carbon capture equipment placed in service during a tax year, and the election would apply to such tax year and all subsequent tax years with respect to such equipment.

The proposal would be effective for facilities or equipment the construction of which begins after December 31, 2021. Proposed changes relating to the election to have the 12-year credit period begin on the first day of the first tax year in which the credit is claimed would be effective for carbon oxide captured and disposed of after December 31, 2021.

The JCT has estimated that the proposal would lose approximately \$2.1 billion 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.

Compared to the Ways and Means proposal, the House bill proposal will significantly increase

credit rates if certain prevailing wage and apprenticeship requirements are met. Relatedly, however, the credit rate would decrease if proposed prevailing wage and apprenticeship requirements are not met.

It is unknown how the prevailing wage and apprenticeship requirements would affect project economics. Similar to the PTC and ITC, however, 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.

In addition, the availability of direct pay would be a positive development if projects are able to satisfy the prevailing wage and apprenticeship requirements. 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.

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.

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. A change from the Ways and Means proposal includes the removal of a minimum capture percentage for other industrial facilities. This is a beneficial change, especially for larger facilities which might have found it difficult to capture 50% of total carbon emissions.

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 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 decrease revenues by approximately \$975 million over a 10-year period.

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 in entities that issue K-1s.

Zero-emission nuclear power production credit

The proposed text includes a new credit under section 45W for the production of electricity from a qualified nuclear power facility.

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 16% 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 would be available and would be subject to the same reduction formula.

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

This proposed provision would terminate on December 31, 2027. The 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 \$23 billion over a 10-year period.

KPMG observation

Section 45W as proposed in the House bill is similar to the provision in the Ways and Means proposal but with enhancements. For instance, the phaseout formula for the bonus credit in the Ways and Means proposal operated such that the credit was reduced 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; while in the House bill the percentage reduction is reduced to 16%. The termination date was also extended one year. The modifications to section 45W in the House bill result in an increase of over \$7 billion to the JCT estimate of the proposal.

Renewable fuels

Extension of incentives for biodiesel, renewable diesel and alternative fuels

For periods beginning after December 31, 2021 and before January 1, 2027, the House bill 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 this proposal would lose approximately \$15.2 billion over a 10-year period.

Extend tax incentives relating to second generation biofuel

For periods beginning after December 31, 2022 and before January 1, 2027, the House bill would extend the second-generation biofuel producer nonrefundable income tax credit of up to \$1.01 per gallon.

The JCT has estimated that this proposal would lose approximately \$106 million over a 10-year period.

Sustainable aviation fuel credit

For periods beginning after December 31, 2022 and before January 1, 2027, the House bill would provide tax incentives for each gallon of 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 House bill provides that “qualified mixture” would mean 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" would mean 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 acid distillates or petroleum. Sustainable aviation fuel is excluded from the definitions of biodiesel and renewable diesel.

The lifecycle greenhouse gas emissions reduction percentage would be determined, in comparison with petroleum based jet fuel, in accordance with the most recent Carbon Offsetting and Reduction Scheme for International Aviation which has been adopted by the International Civil Aviation Organization with the agreement of the United States, or any similar methodology which satisfies the criteria under section 211(o)(1)(H) of the Clean Air Act (42 U.S.C. 7545(o)(1)(H)).

The incentive would 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 would be required to be registered by the IRS under section 4101 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 this proposal would lose approximately \$90 million over a 10-year period.

KPMG observation

Beginning in 2027, upon expiration of the sustainable aviation fuel credit under section 40B and the excise tax credit under section 6426, a credit for sustainable aviation fuel would apply in the new "clean fuel production credit" under section 45CC.

Credit for production of clean hydrogen

The House bill proposes to 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. The House bill is similar to a Ways and Means proposal, but with significant modifications.

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 credit rate is indexed for inflation.

The applicable percentage is as follows: 15% for a facility placed in service before January 1, 2027 that produces qualified clean hydrogen through a process that results in a lifecycle greenhouse gas emissions

rate of 4 kg of CO₂-e to 6 kg of CO₂-e per kg of hydrogen; 20% for qualified clean hydrogen produced through a process that results in a lifecycle greenhouse gas emissions rate of 2.5 kg of CO₂-e to 4 kg of CO₂-e per kg of hydrogen; 25% for qualified clean hydrogen produced through a process that results in a lifecycle greenhouse gas emissions rate of 1.5 kg of CO₂-e to 2.5 kg of CO₂-e per kg of hydrogen; 33.4% for qualified clean hydrogen produced through a process that results in a lifecycle greenhouse gas emissions rate of 0.45 kg of CO₂-e to 1.5 kg of CO₂-e per kg of hydrogen; and 100% for qualified clean hydrogen produced through a process that results in a lifecycle greenhouse gas emissions rate of less than 0.45 kg of CO₂-e per kg of hydrogen.

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. The term would include only emissions through the point of production (well-to-gate).
- “Qualified clean hydrogen” would mean hydrogen that is produced through a process that results in a lifecycle greenhouse gas emissions rate of not greater than 6 kg of CO₂-e per kg of hydrogen.
 - 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, as verified by an unrelated third party.
- A “qualified clean hydrogen production facility” is a facility owned by the taxpayer that produces qualified clean hydrogen.

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.

Projects that commenced construction before the date that is 60 days after the Secretary publishes guidance with respect to these requirements would be treated as eligible for the bonus rate, but such projects would be required to meet the prevailing wage requirements after the date that is 60 days after the Secretary publishes guidance.

The proposal would permit more than one taxpayer to have an ownership interest in the facility and provides for the allocation of the credit in proportion to respective ownership interests in the gross sales from the facility.

For qualified clean hydrogen production facilities placed in service after December 31, 2011, taxpayers may elect to receive a direct payment of this credit under rules described above providing for an elective payment for energy property and electricity from certain renewable resources. Such election must be made separately with respect to each facility, be made for the tax year in which the facility is placed in service (or within 90 days of the date of enactment), and would apply to such tax year and all subsequent tax years with respect to such facility.

The proposal would provide for a reduction of the credit in the case of projects financed with tax exempt bonds and beginning construction after December 31, 2021.

Notably, the proposal would permit a taxpayer to receive both the section 45 credit for electricity produced from renewable resources *and* the credit for the production of clean hydrogen if such electricity is used at a qualified clean hydrogen facility to produce qualified 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 make an irrevocable election to treat specified clean hydrogen facilities (or any portion of such facility) as energy property under section 48. The energy percentage with respect to such property would range from 0.9 to 6% depending on the type of qualified clean hydrogen that the facility is designed and reasonably expected to produce. Specified clean hydrogen production facilities would include facilities placed in service after December 31, 2021, and with respect to which no credit under sections 45Q or 45X have been allowed.

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

The proposal would require the Secretary to issue regulations or guidance to carry out the section, including for determining lifecycle greenhouse gas emissions and the process for requiring verification by unrelated third parties of production and sale of clean hydrogen, no later than one year after the date of enactment.

The proposal would be effective for hydrogen produced after December 31, 2021. Proposed language regarding the reduction of the credit in the case of projects financed with tax exempt bonds would be effective for facilities beginning construction after December 31, 2021. Provisions related to the election to treat the clean hydrogen production facility as energy property would apply to property placed in service after December 31, 2021, and for property the construction of which begins prior to January 1, 2022, only to the extent of the basis is attributable to construction, reconstruction, or erection after December 31, 2021. The proposal to terminate the alternative fuel excise tax credit as it relates to hydrogen would be effective to fuel sold or used after December 31, 2021.

The JCT has estimated that the proposal would lose approximately \$9.2 billion over a 10-year period.

KPMG observation

The proposed new tax credit for clean hydrogen production may incentivize the development of clean hydrogen as a low-carbon alternative energy source.

The proposed credit rate would vary based on the lifecycle greenhouse gas emissions rate of the production process, with the highest credit available of \$3 per kilogram of qualified clean hydrogen produced by the taxpayer if the production process results in a lifecycle greenhouse gas emissions rate of less than 0.45 kg of CO₂-e per kg of hydrogen and prevailing wage and apprenticeship requirements are met. The House bill proposal clarifies that the lifecycle greenhouse gas emission rate would include only emissions through the point of production (well-to-gate).

Notably, a taxpayer who produces electricity from green energy and uses such electricity in the production of clean hydrogen would be eligible for both the section 45 credit and the clean energy hydrogen production credit. The proposal provides that, in such a case, the electricity shall be treated as sold by a taxpayer to an unrelated person, which is important because the section 45

credit generally is not available for a taxpayer who produces energy for its own account.

In addition, the availability of direct pay would be a positive development for these projects and may accelerate the development of this alternative energy source.

Under the proposal, a taxpayer may elect to treat specified clean hydrogen facilities (or any portion of such facility) as energy property under section 48, in lieu of the hydrogen production credit.

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, with such limitation not being applicable to an electric heat pump water heater, an electric heat pump, or a biomass stove;
- 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 identification number requirement would be effective for property placed in service after December 31, 2023. The provisions are scheduled to sunset on December 31, 2025.

The JCT has estimated that the proposal would lose approximately \$13.9 billion over a 10-year period.

Residential energy efficient property

Current law section 25D provides a 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 add a requirement that the battery storage technology must be installed by a “qualified installer,” who must enter into an agreement with the Secretary to provide certain identification information with respect to the installed battery storage technology.

The proposal would eliminate the credit for qualified biomass fuel property expenditures.

The proposal would eliminate the ability to carryforward unused section 25D credits for tax years beginning after December 31, 2022.

The proposal would be effective for expenditures made after December 31, 2021. The Section 25D credit would be made refundable for tax years beginning after December 31, 2023. The proposal is scheduled to sunset December 31, 2031.

The JCT has estimated that the proposal would lose approximately \$24.8 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, but 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 earlier herein.

The proposal provides that for purposes of computing the earnings and profits of a REIT, any amount deductible under section 179D shall be allowed in the year in which the property giving rise to such deduction is placed in service.

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 proposal is scheduled to sunset December 31, 2031.

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 and is scheduled to sunset on December 31, 2031.

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 or 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

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 a gasoline tank capacity not greater than 2.5 gallons, and for vehicles with battery capacity of no less than 50 kilowatt hours and a gasoline tank capacity not greater than 2.5 gallons 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.

Each taxpayer may only receive a credit under this provision for one qualified plug-in electric drive motor vehicles per year.

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:

- Vans: \$80k
- SUVs: \$80k
- Pick-up trucks: \$80k
- Other vehicles (including Sedans): 55k

The credit would be phased out by \$200 for each \$1,000 of the taxpayer's modified adjusted gross income (the lesser of such amount either in the year of acquisition or the preceding tax year) as exceeds \$500,000 for married filing jointly, \$375,000 for head of household, and \$250,000 in any other case.

As compared to the Ways and Means proposal, the House bill increases the MSRP limitation but decreases the modified adjusted gross income phaseout limits.

The taxpayer could elect to transfer the credit to the vehicle dealer, provided 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 30% credit, not to exceed \$7,500, 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 credits are scheduled to sunset on December 31, 2031

The JCT has estimated that the proposal would lose approximately \$9.2 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

The proposal would provide a new credit for previously owned qualified plug-in electric drive vehicles. Buyers could claim a base credit of \$2,000 for the purchase of qualifying used EVs, with additional incentives for battery capacity. The credit is capped at the lesser of \$4,000 credit or 50% of the sale price. The credit would be refundable. The sale price cannot exceed \$25,000.

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 taxpayer could elect to transfer the credit to the vehicle dealer, provided 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.

The credit would apply to vehicles acquired after December 31, 2021. The proposal is scheduled to sunset on December 31, 2031.

The JCT has estimated that the proposal would lose approximately \$1.7 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 the lesser of (i) 15% of the cost of such vehicle (30% in the case of a vehicle not powered by a gasoline or diesel internal combustion engine) or (ii) the incremental cost of such vehicle. The incremental cost of any qualified commercial electric vehicle is an amount equal to the excess of the purchase price for such vehicle over such price of a comparable vehicle.

Taxpayers (such as dealers) who acquire commercial electric vehicles for the purpose of leasing such vehicle to an individual may elect to take a credit equal to the amount that would be available had the individual purchased the vehicle. This provision was not included in the Ways and Means proposal. There is a recapture provision in the proposal that would effectively apply the income limits under proposed section 36C (the qualified plug-in electric drive motor vehicles credit for individuals) to any credits claimed by a taxpayer who leases a commercial electric vehicle to an individual.

In the case of vehicles acquired by tax exempt entities, the tax exempt entity would be able to receive a direct payment of such credit under proposed section 6417(b).

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 15 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 \$4.8 billion over a 10-year period.

KPMG observation

The addition of a provision allowing taxpayers who acquire commercial electric vehicles and lease them to individuals is favorable for automotive dealers who offer cars for sale or for lease. Under the Ways and Means proposal there was no credit available for a leased electric vehicle. This new provision, at least in theory, would allow automotive dealers to retain price parity, post-credit, for sales and leases.

It is not clear how the recapture provision would be implemented for vehicles leased to individuals who would not be eligible for a full credit under proposed section 36C, as the taxpayer's credit recapture would be dependent on the individual lessee's modified adjusted gross income and such information would generally not be available to the lessor taxpayer.

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.

KPMG observation

As businesses and communities seek to add more charging station infrastructure, the proposed credit could be an important tool for motivating investment.

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 of 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 30% refundable tax credit for qualified electric bicycles placed into service after December 31, 2021 and before January 1, 2026. According to the proposed legislative text, the bicycle must cost \$3,000 or less to be eligible for the credit.

Under the proposal, taxpayers could claim a credit of up to \$1,800 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).

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.

There is an election available for the retailer which sold a qualified electric bicycle to take the credit.

The JCT has estimated that the proposal would lose approximately \$4.1 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 \$5 billion in credits each year from 2022 to 2023 and \$1.875 billion each year from 2024-2031.

\$800 million in credits each year from 2022 to 2023 and \$300 million in credits for each year from 2024 to 2031 are reserved for projects in automotive communities. Automotive Communities means a census tract that has experienced major job losses in the automotive manufacturing sector since January 1, 1994, as determined by the Secretary.

Additionally, \$800 million in credits each year from 2022 to 2023 and \$300 million in credits for each year from 2024 to 2031 are reserved for projects in energy communities. Energy communities are defined as census tracts in which a coal mine has closed after December 31, 1999 or in which a coal-fired electric generating unit has been retired after December 31, 2009.

In order for a project to be eligible for 30% 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.

A 6% credit is available to projects which do not meet the prevailing wage and apprenticeship requirements.

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 JCT has estimated that the proposal would lose approximately \$7.6 billion over a 10-year period.

KPMG observation

The section 48C proposal in the House bill is largely consistent with the proposal in the Ways and Means proposal with some changes, most notably the increased allocation amounts. The increased allocation amounts along with broader QAEP categories and direct pay could make section 48C a very significant opportunity for many taxpayers.

Credit for labor costs of installing mechanical insulation property

The House bill would provide a new credit under section 45Z for labor costs incurred by a taxpayer in installing mechanical insulation property into a mechanical system which was originally placed in service not less than one year before the date on which such mechanical insulation property is installed.

The base credit rate is 2%, which is increased to 10% for projects meeting prevailing wage and apprenticeship requirements.

The credit is available for costs paid starting in 2022 through the end of 2025.

The JCT has estimated that the proposal would lose approximately \$5.9 billion over a 10-year period.

Advanced manufacturing investment credit

The House bill would create a new investment tax credit under section 48E for investments in advanced manufacturing facilities. The base credit rate would be 5%, which would be increased to 25% for projects meeting prevailing wage and apprenticeship requirements.

The investment tax credit would be available for property for the manufacturing of semiconductors or semiconductor tooling equipment, including buildings and equipment that are integral to such manufacturing, which commences construction before January 1, 2026.

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

The credit would be available for property placed in service after December 31, 2021. For property which commenced construction prior to January 1, 2022 the credit would be available only to the extent of basis attributable to construction occurring after December 31, 2021. The proposal is scheduled to sunset on December 31, 2025.

The JCT has estimated that the proposal would lose approximately \$10.2 billion over a 10-year period.

KPMG observation

This credit was not included in the Ways and Means proposal, although similar provisions have been included in legislative proposals over the last year.

Advanced manufacturing production credit

The proposal would provide a new production tax credit under section 45AA for each eligible component that is produced and sold. Eligible components would include solar and wind parts including solar polysilicon, wafers, cells, and modules, and wind blades, nacelles, towers, and offshore foundations.

The credits amounts generally would be determined on a mass or watt capacity basis depending on the type of component. For example, in the case of a solar module the credit would be equal to the product of \$0.07 multiplied by the capacity of the module (expressed on a per direct current watt basis).

The amount of credit allowed for eligible components is increased by 10% if the final assembly of the components is at a facility in the United States which operates under a union-negotiated collective bargaining agreement.

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

The credits would be available for eligible components produced and sold before January 1, 2027. For components sold after that date, the credit is reduced by 25% each year, and is unavailable for components sold in 2030 and beyond.

The JCT has estimated that the proposal would lose approximately \$2.5 billion over a 10-year period.

KPMG observation

The proposed section 45AA credit is intended to boost domestic production of wind and solar components and is likely designed to coordinate with the domestic content requirements proposed to apply to investment tax credits and production tax credits available to wind and solar. It will be interesting to watch whether this credit, if passed, offers enough of an incentive to result in a sufficient amount of domestically produced wind and solar components to satisfy demand and make the proposed direct pay phasedown for not satisfying domestic content requirement less impactful. This provision was not included in the Ways and Means proposal.

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.

A prior version of the House bill contained language relating to a "gross-up of payment in case of sequestration"; however, this language was stricken from the bill prior to House passage.

The proposal would be effective January 1, 2022 and would sunset December 31, 2031. Unused amounts may be reallocated through 2036.

The JCT has estimated that the proposal would lose approximately \$7.8 billion over a 10-year period.

Reinstate Superfund excise taxes on crude oil and imported petroleum products

For periods beginning after June 30, 2022, the House bill would reinstate the Hazardous Substance Superfund tax ("Superfund tax") at a rate of 16.4 cents per barrel. The Superfund tax would be indexed for inflation beginning in calendar year 2023.

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

The JCT has estimated that this proposal would raise approximately \$24.8 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 if the proposal were enacted in its current form.

Incentives for clean electricity and clean transportation

Clean electricity production and investment credits

The proposal would create a new emissions-based incentive for electric generating facilities, effective for facilities that begin construction after 2026.

Taxpayers could choose between a production tax credit (PTC) under new section 45BB ("Section 45BB PTC") or an investment tax credit (ITC) under new section 48F ("Section 48F ITC").

Any power facility with any technology could qualify for the credits, so long as the facility's greenhouse gas emissions rates are at or below zero. For this purpose, the greenhouse gas emissions rate means the amount of greenhouse gases emitted into the atmosphere by a facility in the production of electricity, expressed as grams of CO₂e ("carbon dioxide equivalent") per kilowatt. In the case of a facility which produces electricity through combustion or gasification, such as a biomass facility, the greenhouse gas emissions rate for such facility is equal to the net rate of greenhouse gases emitted into the atmosphere by such facility taking into account lifecycle greenhouse gas emissions.

Section 48F ITC would also be available for grid improvement property and energy storage property.

The Secretary will publish annually a table that sets forth the greenhouse gas emissions rates for types or categories of facilities. In the case of any facility for which an emissions rate has not been established, a taxpayer may file a petition with the Secretary for determination of the emissions rate with respect to the facility.

For the Section 45BB PTC, the base rate would be .3 cents per kilowatt hour and the bonus rate would be 1.5 cents per kilowatt hour. For the Section 48F ITC, the base rate would be 6% and the bonus rate would be 30%. The Section 45BB PTC rate would be adjusted for inflation using 2021 as the year against which inflation is measured.

The bonus rate would be available to:

- Facilities with a capacity of less than 1 megawatt and
- Facilities that satisfy the prevailing wage and apprenticeship requirements (requirements described above under the proposed extension of the PTC/ITC rules; see prior section).

For purposes of the determination of the emissions rate, any greenhouse gases emitted into the atmosphere by a facility does not include qualified carbon dioxide that is captured by the taxpayer and utilized in a manner described in section 45Q(f)(5) – generally limited to situations in which the qualified carbon dioxide is used in a commercial or industrial process other than enhanced oil recovery. Very generally, section 45Q(f)(5)

The Section 45BB PTC would be available for a 10-year period beginning with the date the facility is placed in service. If a taxpayer places in service a "new unit," to an existing facility and the construction of that new unit began after 2026, the new unit would qualify for a new 10-year Section 45BB PTC period.

The Section 48F ITC would be claimed in the year the asset was placed in service. If a taxpayer places in service a "new unit," to an existing facility and the construction of that new unit began after 2026, the new unit would qualify for the Section 48F ITC. If the Secretary determines that the actual greenhouse gas emissions rate for a qualified facility was greater than 10 grams of CO₂e per kilowatt after the placed

in service date, any property for which a section 48F ITC was allowed could be subject to ITC recapture if the determination occurs in the first 60 months after the facility is originally placed in service.

The Section 45BB PTC and Section 48F ITC would phase out for projects that begin construction on the later of the following:

- The year following the year in which annual greenhouse gas emissions from the production of electricity in the United States is equal to or less than 25% of the annual greenhouse gas emissions from the production of electricity for calendar year 2021 or
- 2032.

The applicable Section 45BB PTC rate or Section 48F ITC rate would be 75% for the first year of the phaseout (possibly 2033 depending on emissions reductions) and 50% for the second year of the phase out (possibly 2034, depending on emissions reductions).

Facilities financed with tax-exempt bonds would be subject to the same reduction in the PTC/ITC rate as under the proposed extension of the PTC and ITC described above.

Similar to the proposed extension of the PTC rules, facilities that satisfy the domestic content requirements would be eligible for a 10% increase in the Section 45BB PTC rate. Similar to the proposed extension of the ITC rules, facilities that satisfy the domestic content requirements but not the prevailing wage or apprenticeship requirements would be eligible for a 2% increase in the Section 48F ITC rate; and facilities that satisfy both the domestic content requirements and the prevailing wage and apprenticeship requirements would be eligible for a 10% increase in the Section 48F ITC rate.

An elective direct payment would be available for the Section 45BB PTC and the Section 48F ITC but the proposal provides that refundability would not be available if the facility didn't satisfy the domestic content requirements.

Similar to the extension of the ITC rules, Section 48F would provide a mechanism for taxpayers to apply for an increase Section 48F ITC rate – of either 10 or 20% – if they build facilities in eligible low-income communities, effective for projects that begin construction after 2026.

An otherwise eligible facility can claim either the section 45BB PTC or the Section 48F ITC but not both.

Facilities that claim either the section 45BB PTC or the section 48F ITC cannot claim the PTC, ITC, carbon oxide sequestration credit, the credit for production from advanced nuclear power facilities, or the qualifying advanced coal production credit.

The JCT has estimated that the production and investment credits would reduce revenues by \$43.2 billion over 10 years.

KPMG observation

Section 45BB and Section 48F are intended to install a technology neutral regime to encourage the production of electricity.

This change may have the effect of making some technologies that are eligible for existing PTCs or ITCs ineligible for the Section 45BB PTC or Section 48F ITC. For instance, under the PTC rules, biomass facilities are allowed to burn fossil fuel in an amount necessary for flame startup and stabilization. However, under section 45BB PTC, such combustion activities might prevent the

facility from having net zero carbon emissions equivalents. Landfill gas facilities might similarly fail to satisfy the net zero carbon emissions equivalents if the fuel source, methane gas, is not completely disposed of as part of the combustion process and/or some is released during the production process.

On the other hand, there could be some significant winners. Under the current PTC rules, only incremental hydropower production is eligible for the PTC and then only to the extent of increased capacity. Under the new rules, a new hydropower “unit” at an existing facility would presumably be eligible for the entire Section 45BB PTC rate and not be limited to the incremental capacity limit – assuming the facility is otherwise operated as a net carbon zero facility.

The carve out for carbon dioxide that is sequestered and utilized is quite narrow. Commercial applications for carbon dioxide outside of enhanced oil recovery activities are generally limited. The development of this industry is in its very early stages and it is not clear how much of a market there would be for commercial application of carbon dioxide.

The inability to claim a refund of these credits unless the domestic content requirements are satisfied could also discourage investment in these technologies.

Cost recovery for qualified facilities, qualified property, and grid improvement property

The House bill proposal would provide that any facility described in the clean electricity production credit and any qualified property or grid improvement property described in the clean electricity investment credit would be treated as five-year property under the general depreciation system for purposes of section 168 of the Internal Revenue Code.

This proposal was not included in the prior Ways and Means proposals.

The proposal applies to facilities and property placed in service after 2026.

The JCT has estimated that the proposal would lose approximately \$624 million over a 10-year period.

KPMG observation

This proposal would provide that qualified clean electricity facilities or grid improvement property would be eligible for depreciation over five years, similar to other renewable energy property. This would accelerate cost recovery for expenses to construct this type of facility and provide another incentive for construction.

Clean fuel production credit

The House bill would create a technology-neutral incentive for the domestic production of clean fuels. This proposal was not included in the prior Ways and Means proposals.

The new “clean fuel production credit” under section 45CC would be equal to the product of (1) the applicable amount per gallon with respect to any transportation fuel produced at a qualified facility and sold by the taxpayer to an unrelated person for use in the production of a fuel mixture, for use in a trade or business, or for sale at retail and (2) the emissions factor of such fuel. The applicable amount would be

\$0.20 per gallon (\$0.35 in the case of sustainable aviation fuel) or \$1.00 per gallon (\$1.75 in the case of sustainable aviation fuel) for taxpayers who meet prevailing wage and apprenticeship requirements. These amounts would be adjusted for inflation after 2026.

The Treasury Department would be required to annually publish emissions rates for fuels that are produced using similar feedstocks and production pathways that taxpayers would use for purposes of determining their credit rates. This emissions rate would then be used to compute the emissions factor, with a credit provided for fuels with emissions below 50 kg CO₂e per mmBtu. The lower the emissions rate, the higher the credit would be.

Between now and 2030, qualifying fuels would be required to become increasingly cleaner in order to qualify for the credit. Fuels produced before 2030 may qualify if the fuel's lifecycle emissions are less than 50 kg of CO₂e per mmBtu (35 kg CO₂e per mmBtu in the case of aviation fuel). These amounts are reduced to 25 kg CO₂e per mmBtu for 2031 and beyond.

The credit would phase out the latter of 2031 or when emission targets are achieved (when the transportation sector emits 75% less carbon than 2021 levels), at which point the incentives would be phased out over three years. Facilities would be able to claim a credit at 100% in the first year, then 75%, then 50%, and then 0%.

Qualifying production would be restricted to production in the United States.

No credit would be allowed at a facility which includes property for which a credit is allowed under section 45Q, 45X, or the section 48 ITC for clean hydrogen production facilities during the tax year.

Fuels would be required to be transportation grade – suitable for use in a highway vehicle or aircraft – but could be used for any business purpose, including as transportation fuel, industrial fuel, or for residential or commercial heat. No credit would be allowed for non-aviation fuel which is derived from coprocessing biomass with a feedstock which is not biomass.

Taxpayers would be eligible to elect direct payment of the credits, in a similar manner to other provisions.

The proposal would apply to transportation fuel produced after December 31, 2026.

The JCT has estimated that the proposal would lose approximately \$9.7 billion over a 10-year period.

KPMG observation

This proposal would create an incentive for the domestic production of clean fuels. The credit would not be effective, however, until 2027. In addition, the credit would phase out the latter of 2031 or when emission targets are achieved.

The credit for sustainable aviation fuel credit under section 40B would apply to fuel sold after December 31, 2022 until December 31, 2026.

Social safety net

Child tax credit

The JCT estimated that the various provisions (described below) related to the child tax credit would have a combined impact of decreasing revenues by approximately \$184.6 billion over 10 years.

Modifications 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 amount of \$2,000 per qualifying child. This safe harbor amount is phased down ratably for married joint filers with MAGI between \$60,000 and \$120,000, head of household filers with MAGI between \$50,000 and \$100,000, and MAGI between \$40,000 and \$80,000 for all other filers.

Proposal

The House bill 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. Furthermore, if a taxpayer filed a joint tax return with another individual in the tax year used to determine the taxpayer's advance payment eligibility and amount, the proposal would permit the Secretary to disclose to the taxpayer any return information of the other individual which is relevant in determining the taxpayer's advance payment.

The proposal concerning the disclosure of information related to joint filers and the advance payment would take effect on the date of enactment of the proposed legislation. All other proposals would apply to tax years beginning, and payments made, after December 31, 2020.

KPMG observation

While the House bill proposal is substantially similar to the Ways and Means proposal, the House bill proposal contains two provisions that were not included in the Ways and Means proposal. The

additional proposals include the proposal concerning the disclosure of information related to joint filers and the advance payment, as well as a proposal that would treat advance payments issued by U.S. possessions as advance payments under section 7527A for purposes of reconciling the CTC and advance payment.

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 enacted with the TCJA and 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:

- 1) 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,
- 2) Increased the age limit of a qualifying child to include a dependent child under the age of 18,
- 3) Made the CTC fully refundable for a taxpayer (or in the case of a joint return, either spouse) with a principal place of abode in the United States for more than one-half the tax year, and
- 4) 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 House bill 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, including eliminating the 50% limit on advance payments in effect for tax year 2021. Thus, advance payments would be made monthly for the full 2022 tax year, rather than for half the year as in 2021.

The proposal would direct the Treasury to establish a temporary program for making these monthly advance payments to taxpayers during 2022 in amounts equal to 1/12 of what the Treasury estimates to be the full refundable portion of the CTC amount based on the taxpayer's 2021 return (or 2020 return if the 2021 return is not available) considering the passage of time with respect to the ages and status of the taxpayer's qualifying children. The proposal also would expand the information the Secretary may use to more accurately estimate a taxpayer's CTC for 2022 for purposes of determining the advance payment amount to include any information provided, or known, to the Secretary.

The proposal would generally disallow advance payments to taxpayers whose MAGI for purposes of determining their advance payment amount is greater than \$150,000 in the case of a joint filer, \$112,500 in the case of a head of household filer, and \$75,000 in the case of any other filer. However, the proposal provides for an elective "look-back rule," that would allow taxpayers to elect to use 2021 MAGI for purposes of the income phaseout of the 2022 CTC and advance payment. When and how this election would be made is currently unclear, as the proposal would grant the Secretary the authority to provide the timing and manner of making this election.

The proposal would 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.

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

While the House bill proposal is substantially similar to the Ways and Means proposal, the House bill deviates from the Ways and Means proposal in that it would:

- 1) Modify the “look-back rule” that would allow taxpayers to use prior-year income information for purposes of determining the phaseout of the CTC by providing that it would apply on an elective, rather than automatic, basis;
- 2) Generally prevent advance payments from being received by taxpayers whose MAGI for purposes of determining their advance payment amount is greater than \$150,000 in the case of a joint filer, \$112,500 in the case of a head of household filer, and \$75,000 in the case of any other filer. Under the Ways and Means proposal, taxpayers whose MAGI exceeded the above thresholds would still potentially qualify for advance payments; and
- 3) No longer inflation adjust the CTC, ODTTC, and phase-out thresholds applicable to the additional CTC amount provided under ARPA.

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).

Similarly, 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 2021.

Fully refundable child tax credit after 2022

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. As discussed above, the House bill proposal would extend these ARPA modifications through tax year 2022.

Proposal

The House bill proposal would make the CTC permanently fully refundable, regardless of a taxpayer's earned income, for all tax years after 2022 for a taxpayer (or, in the case of a joint return, either spouse) with a principal place of abode in the United States for more than one-half of the tax year.

The proposal would be effective for tax years beginning after December 31, 2022.

KPMG observation

As noted, under current law, an individual who claims the foreign earned income exclusion is not eligible to claim any refundable portion of the CTC. The House bill proposal would eliminate this limitation, but would impose a new limitation requiring an individual (or, in the case of a joint return, either spouse) to have a principal place of abode in the United States for more than one-half of the tax year. This new limitation would generally prevent certain individuals eligible for the foreign earned income exclusion for more than one-half of the tax year from claiming any refundable portion of the CTC. This is due to the requirement that provides that an individual generally cannot have an abode in the United States in order to be eligible to claim the foreign earned income exclusion. However, this modification would appear to allow some U.S. persons who qualify for a partial foreign earned income exclusion in the year they depart or return to the United States to claim any refundable portion of the CTC. Additionally, this modification would appear to allow U.S. persons who have an abode in the United State but qualify for the foreign earned income exclusion because they are serving in an area designated by the President of the United States by Executive order as a combat zone in support of the Armed Forces of the United States to claim any refundable portion of the CTC.

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:

- 1) Lowering the minimum age from 25 to 19 (18 for certain former foster and homeless youth, and 24 for certain eligible students);
- 2) Eliminating the maximum age at which the credit was available (age 64);
- 3) Increasing the maximum credit and phaseout percentage from 7.65% to 15.3%;
- 4) Increasing the maximum credit available from \$543 to \$1,502;
- 5) 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;

- 6) Increasing the earned income level at which the maximum credit amount is reached from \$4,220 to \$9,820; and
- 7) Increasing the amount of income at which phaseout begins 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. ARPA also increased the amount of “disqualified income” (investment income) an individual may have without losing the benefit of the EITC from \$3,650 to \$10,000.

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 extend through tax year 2022 ARPA’s temporary changes to the EITC for childless workers and would adjust the relevant thresholds for inflation for 2022.

The proposal would also allow a taxpayer whose earned income for tax year 2022 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.

The proposal provides funds for administration of the EITC within the territories.

This proposal would be effective for the 2022 tax year.

The JCT estimated that the provision would decrease revenue by approximately \$13.3 billion over 10 years.

KPMG observation

The proposal would allow more childless workers to qualify for the EITC by increasing the income thresholds and expanding the age criteria for an additional tax year. This proposal differs from the Ways and Means proposal in that it extends the ARPA modifications by one year instead of making them permanent.

Expanding access to health coverage and lowering costs

Extend the American Rescue Plan Act 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 expand the PTC by extending the applicable contribution percentages of household income used for determining the PTC through 2025 and extending eligibility to taxpayers with household income above 400% of the federal poverty line through 2025. In addition, the proposal provides that applicable contribution percentages would not be indexed until 2027.

The proposal would be effective for tax years beginning after December 31, 2021 and would sunset on December 31, 2025.

Cost estimates are to be provided by the CBO.

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 through 2025. The proposal further provides that household income thresholds will not be indexed until 2027.

The proposal would be effective for tax years beginning after December 31, 2021 and would sunset on December 31, 2025.

Cost estimates are to be provided by the CBO.

KPMG observation

While not eliminating the requirement that job-based coverage be affordable, the proposal has eliminated any inflation indexing such that premiums must remain less than 8.5% of household income for purposes of determining PTC eligibility for tax years through 2025.

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.

Cost estimates are to be provided by the CBO.

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 would end on December 31, 2025.

Cost estimates are to be provided by the CBO.

KPMG observation

It appears this proposal is intended to temporarily 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 2022 and adjust the income level to treat those who qualify as having an income of 150% of the federal poverty line (or 133% for any week beginning during 2021).

The proposal would be effective for tax years beginning after December 31, 2021 and would sunset on December 31, 2022.

Cost estimates are to be provided by the CBO.

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 proposal would be effective for coverage months after December 31, 2021.

The JCT has estimated that the proposal would lose approximately \$344 million over a 10-year period.

Exclude certain dependent income for purposes of PTC

For purposes of determining PTC eligibility and amount, household income is defined as including modified adjusted gross income from all family members for which personal exemptions are allowed, so long as each of those individuals is required to file a federal income tax return.

The proposal would exclude income of any dependent of the taxpayer under age 24 as of the last day of the calendar in which the taxpayer's tax year begins. However, the proposal would only apply to the first \$3,500 of the dependent's income, to be adjusted for inflation after 2023.

The proposal would be effective for tax years beginning after December 31, 2022 and would sunset on December 31, 2026.

Cost estimates are to be provided by the CBO.

KPMG observation

It appears this proposal is intended to allow dependents to make a small amount of income from a part-time job without jeopardizing the family's PTC eligibility or amount.

Require coverage and cost-sharing for certain insulin products

This new proposal would ensure coverage by a group health plan of at least one of each type and dosage form of insulin under private insurance as well as ensure coverage of these insulin products before the application of any deductible and limits other cost-sharing to no more than \$35 for a 30-day supply.

The proposal would apply to group health plan years beginning on or after January 1, 2023.

Cost estimates are to be provided by CBO.

Establish a program overseeing pharmacy benefit manager services

This new proposal would require that group health plan sponsors receive a semi-annual report on the costs, fees, and rebate information associated with their pharmacy benefit manager contracts. These reports must be generated by the entities providing pharmacy benefits management services and require the inclusion of certain specific information to be disclosed to the group health plan sponsors. The proposal provides that the Secretary of Health and Human Services shall enforce the reporting requirements, in consultation with the Secretaries of Labor and Treasury.

The proposal would apply to group health plan years beginning on or after January 1, 2023.

Cost estimates are to be provided by CBO.

Pathway to practice medical school scholarship program

To increase the number of medical professionals serving rural and medically underserved communities, the proposal would create a medical scholarship program. Beginning in 2023, the Secretary of Health and Human Services would 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 would be in the form of a refundable tax credit to the educational institution.

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

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. The proposal is substantially similar to a proposal in the Ways and Means bill.

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 of the Ways and Means proposal, 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 \$177 million over a 10-year period.

KPMG observation

A proposal providing a phase out of the excise tax under section 4968 for certain educational institutions that provide sufficient qualified aid awards to student that was included in the Ways and Means bill was not included in the House bill.

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.

The proposal is similar to a proposal in the Ways and Means bill. However, the House bill added an expiration date to the provision as noted below.

This proposal would be effective for tax years beginning after December 31, 2021 and would sunset December 31, 2025.

The JCT estimated that the provision would decrease revenues by approximately \$880 million 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.

Modify limitation on deduction for state and local taxes

Prior to the TCJA, individual taxpayers and non-grantor trusts and estates were generally allowed an itemized deduction for state and local real property and income (or sales) taxes (SALT) paid or accrued during the tax year, as well as for foreign real property taxes. The TCJA imposed a temporary \$10,000 (\$5,000 if married filing a separate return) limit on the SALT deduction and suspended the foreign real property tax deduction available to individuals for tax years 2018 through 2025. The TCJA's modifications do not apply to any SALT or foreign real property taxes incurred in carrying on a trade or business. Without any changes, the TCJA's limitations on these deductions expire after the 2025 tax year.

The TCJA's modifications to the SALT and foreign real property tax deductions did not make reference to a provision in the Internal Revenue Code permitting a deduction for real estate taxes paid or accrued to a

cooperative housing corporation by a tenant-stockholder (the tenant-stockholder deduction). However, according to the JCT General Explanation of the TCJA, it was intended that the tenant-stockholder deduction be subject to the SALT deduction limitation.

Proposal

The House bill would extend the TCJA's temporary SALT deduction limitation through tax year 2031, but would increase the limitation to \$80,000 (\$40,000 in the cases of an estate, trust, or married individual filing a separate return) for tax years 2021 through 2030. The limitation would revert to \$10,000 (\$5,000 in the cases of an estate, trust, or married individual filing a separate return) for tax year 2031. Under the TCJA, estates and non-grantor trusts are allowed the higher deduction limitation that is also available for single and married filing jointly taxpayers. The House bill, however, provides that they would be subject to the more limited deduction applicable to married filing separate returns going forward. The SALT deduction would not be subject to a limitation in tax years beginning after December 31, 2031.

The proposal would include the tenant-stockholder deduction in the aggregate amount of taxes subject to the SALT limitation for tax years beginning after December 31, 2020. As noted above, the current language of the temporary SALT deduction limitation does not make reference to the tenant-stockholder deduction. As a result, the amended language would be in effect for tax years beginning after December 31, 2020, but not for tax years 2018 through 2020. However, the proposal provides that no inference may be made with respect to the proper application of the SALT deduction and the tenant-stockholder deduction for tax years beginning before January 1, 2021.

The proposal would allow the Secretary to designate taxes paid in a tax year before January 1, 2031, as paid or deductible in a different tax year to the extent it is necessary to prevent the circumvention of the SALT deduction limitation. This provision would give the Secretary the right to prevent the prepayment of state income or real estate taxes that normally would be paid during a tax year when a lower limit is in effect.

The House bill would extend the TCJA's temporary suspension of the foreign real property tax deduction through tax year 2031 and would include in this suspension any tenant-stockholder deduction for foreign real property taxes. The foreign real property deduction would be available in tax years beginning after December 31, 2031.

This proposal would be effective for tax years beginning after December 31, 2020.

KPMG observation

The inclusion of the SALT deduction limitation increase in the House bill is somewhat surprising, as it was not included in the Green Book, the Ways and Means proposal, the White House's recently published "Build Back Better Framework," or the House Rules Committee's October 28 proposal. While the proposed SALT deduction limitation increase may appear as a tax cut at first-glance, the JCT estimates this provision would actually increase revenue over a 10-year period. This is because the limitation under the TCJA was set to expire on December 31, 2025, and would not be in effect for tax years after 2025. The proposal would extend the limitation into uncapped years through tax year 2031. The extension of the limitation would result in reduced deductions for an additional six years for high-income taxpayers who otherwise would be eligible to deduct state and local taxes in excess of the proposal's increased limit of \$80,000 (\$40,000 for married filing separately, estates and trusts).

Additionally, the House bill would not modify the TCJA's temporary suspension of the overall

limitation on itemized deductions for tax years 2018 through 2025 that is set to expire for tax years beginning after December 31, 2025. Thus, for tax years 2026 through 2031, high-income taxpayers who itemize deductions may potentially be subject to both the House bill's SALT tax deduction limitation and an overall limitation that may reduce by up to 80% the benefit of their itemized deductions through the income-based phase-out.

KPMG observation

Under the proposal, foreign real property taxes would remain non-deductible for tax years 2018 through 2025 and the suspension of the deduction would be extended until December 31, 2031. This would further reduce deductions for U.S. taxpayers with foreign real estate who otherwise would be eligible to deduct foreign real property taxes for tax years beginning after December 31, 2025.

KPMG observation

As under the proposal the increased SALT deduction limitation would go back to \$10,000 in 2031, taxpayers could be incentivized to prepay their 2031 taxes in 2030 to fully utilize the higher deduction limit. Recognizing this incentive, the House bill proposal would provide the Secretary with the authority to issue regulations and guidance disallowing the deduction of state and local taxes that are paid prior to the 2031 tax year but relate to a different tax year. As a result, taxpayers may not be able to accelerate the deduction of state and local income and real property taxes related to tax year 2031 into tax year 2030.

KPMG observation

The proposed increase in the SALT deduction limitation from \$10,000 to \$40,000, if enacted, may enhance the benefits of creating multiple trusts due to the potential for tax savings inherent in splitting income among additional taxpayers and multiplying available deductions.

KPMG observation

As mentioned, presently the SALT deduction limitation enacted by the TCJA makes no reference to the tenant-stockholder deduction. While the JCT General Explanation of the TCJA indicates that it was intended that the tenant-stockholder deduction be subject to the SALT deduction limitation, it also states in a footnote that a correction may be needed to achieve this result. The House bill proposal would appear to make this correction by including the tenant-stockholder deduction in the aggregate amount of taxes subject to the SALT limitation for tax years beginning after December 31, 2020. While this correction would not be retroactive to tax years 2018 through 2020, the House bill would provide that no inference may be made with respect to this provision and the proper application of the SALT deduction and the tenant-stockholder deduction in prior tax years. Thus, it remains unclear whether the tenant-stockholder deduction is limited by the SALT deduction limitation for tax years 2018, 2019, and 2020.

Other provisions

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 ARPA expanded the set of applicable employees under section 162(m) to include an additional "five highest compensated employees" beyond those already covered by section 162(m), beginning in tax years after December 31, 2026.

The House bill would apply rules similar to the section 414 aggregation rules for covered health insurance providers (bringing in the single employer concept under subsection (b), (c), (m), or (o) of section 414) to the general rule under section 162(m) and expand upon the definition of applicable employee 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 proposal would be effective for tax years beginning after December 31, 2021.

The JCT has estimated this proposal would increase revenue by \$7.2 billion over the 10-year budget window.

KPMG observation

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

The House bill does not include the Ways and Means proposal that would have accelerated the 2027 effective date of the ARPA provision expanding section 162(m) to cover an additional five covered employees.

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 proposal is the same as the proposal contained in the Ways and Means bill.

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.

Treatment of certain qualified sound recording productions

The House bill 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 proposal is substantially similar to the Ways and Means proposal.

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 budget window.

Refund claim mechanism for previously-taxed 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 that this proposal would decrease revenues by approximately \$4 million over a 10-year period.

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 could 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.

Treatment of financial guaranty insurance companies as qualifying insurance corporations under passive foreign investment company rules

This proposal is substantially identical to a prior Ways and Means proposal. 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.

In contrast, the prior Ways and Means proposal also provided that entities that meet the definition of a financial guaranty insurance company would also be deemed to satisfy the requirement that the corporation be predominantly engaged in an insurance business. Thus, under the current proposal, a financial guaranty insurance company must be predominantly engaged in an insurance business.

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.

KPMG observation

This provision would address an issue under the TCJA that effectively prevented most financial guaranty companies from meeting the definition of qualifying insurance companies. Because the 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, concluded 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.

Extension of period of limitation for certain legally married couples

Following the Supreme Court's decision in *United States v. Windsor*, allowing the IRS to recognize same-sex marriages, the IRS issued Revenue Ruling 2013-17 on August 29, 2013. This ruling allowed affected taxpayers to amend their tax returns with respect to their marital status for tax years where they were legally married but could not file joint returns due to prevailing law at that time. The ruling did not change the limitation that amended returns generally must be filed within three years of the due date (or extended due date), so same-sex couples lawfully married before 2010 could not amend their returns to change their marital status for tax years prior to 2010, considering that the ruling was issued in August 2013.

Proposal

The proposal would allow same-sex couples to file amended tax returns to claim married filing joint status back to their year of marriage. Married filing joint status is generally more beneficial than the single status that was otherwise available to married same-sex couples before 2013. Thus, while no change to returns would be permissible other than to change the filing status to married filing joint, this change in status may provide eligible same-sex married couples an opportunity to claim credits and refunds otherwise unavailable due to the statute of limitations. Such amended returns must be filed by the extended due date for tax returns for the year that includes the date of enactment of the legislation. Thus, if the legislation were to be enacted in 2021, the amended returns would be due by October 15, 2022.

This proposal would be effective as of the date of enactment.

The JCT estimates this proposal would decrease revenue by approximately \$55 million over a 10-year period.

KPMG observation

As mentioned, married filing joint status is generally more beneficial than the single status that was otherwise available to same sex-couples before 2013. Thus, some couples may be able to claim refunds as far back as 2004, if they married in 2004 in Massachusetts, the year that same-sex marriage became legal in that state. Note that couples who did not take advantage of Revenue Ruling 2013-17 to amend their returns for the years 2010-2012 would be able to do so under this proposal.

Allowance of an above-the-line deduction for union dues

Prior to 2018, union dues were deductible as a miscellaneous itemized deduction, subject to a limitation of 2% of AGI. Under current law, all miscellaneous itemized deductions, including unreimbursed employee expenses such as union dues, are suspended for tax years 2018 through 2025.

Proposal

The House bill 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, and before January 1, 2026.

The JCT estimates this proposal would decrease revenue by nearly \$1.77 billion over the 10-year budget window.

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 for tax years 2022 through 2025. 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 be subject to the TCJA's suspension employer-provided of miscellaneous itemized deductions through tax year 2025.

Temporary increase in employer-provided child care credit

The House bill proposes to increase the section 45F credit for qualified child care expenses from 25% to 50% and increase the accompanying maximum credit limitation from \$150,000 to \$500,000.

The section 45F credit generally applies to amounts paid or incurred for the operating costs or under a contract with a qualified child care facility or to acquire, construct, rehabilitate, or expand property which is to be used as part of a qualified child care facility by the taxpayer.

This proposal was not included in the Ways and Means bill.

The proposal is effective for tax years beginning after December 31, 2021 and is scheduled to sunset on December 31, 2025.

The JCT has estimated that the proposal will decrease revenues by \$166 million over 10 years.

KPMG observation

This credit increase was not included in the Ways and Means proposal. A Ways and Means proposal to permanently increase the exclusion for employer-provided dependent care assistance from \$5,000 to \$10,500 was not included in the House bill.

Payroll credit for compensation of local news journalists

The House bill would allow an eligible local news journalist employer 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 for subsequent quarters. Applicable wages could not exceed \$12,500.

An eligible local news journalist employer would be any employer which is an eligible local news organization or a qualifying broadcast station, which employs local news journalists

The credit would not be allowed for the U.S. government or any agency or instrumentality.

The proposal would be effective for wages paid in calendar quarters beginning after the date of enactment and beginning before the date that is five years after the first day of the first calendar quarter to which this section applies. The proposal is scheduled to sunset December 31, 2026.

The JCT estimates this proposal would decrease revenue by \$1.67 billion over the 10-year budget window.

Above-the-line deduction for employee uniforms

Prior to 2018, work clothes and employee uniform costs were deductible as a miscellaneous itemized deduction, subject to a 2% of AGI limitation, if the clothes were not suitable for everyday wear and were required for employment. Under current law, all miscellaneous itemized deductions, including unreimbursed employee expenses such as work uniforms, are suspended for tax years 2018 through 2025.

Proposal

The House bill would allow an above-the-line deduction of up to \$250 for work clothing and employee uniforms. The uniforms or work clothing must be required to be worn as a condition of employment and must not be suitable for everyday wear.

The proposal would be applicable to tax years beginning after December 31, 2021, and before January 1, 2025.

The JCT estimates this proposal would decrease revenue by nearly \$2.26 billion over the 10-year budget window.

KPMG observation

The proposal would allow more employees to deduct the cost of uniforms or work clothing regardless of whether they choose to claim the standard deduction or itemized deductions for tax years 2022 through 2024. In addition, as an above-the-line deduction, uniform and work clothing costs would not be subject to the 2% of AGI limitation imposed on miscellaneous itemized deductions, and thus would not be subject to the TCJA's suspension of miscellaneous itemized deductions through tax year 2025.

Expenses in contingency fee cases

Section 138518 of the House bill would modify current law to allow attorneys to deduct litigation costs paid in the ordinary course of business, and for which repayment is contingent on a recovery by judgment or settlement, when paid or incurred. Under current law, the deduction generally is deferred until it is determined whether the amounts will be repaid, at the conclusion of the litigation.

The provision generally is proposed to apply to amounts paid, incurred, or received in tax years beginning after the date of enactment.

The JCT estimated that the proposal would lose approximately \$2.46 billion over a 10-year period.

Increase in research tax credit against payroll tax for qualified small businesses

The House bill proposal would increase the section 41(h) research tax credit election to offset payroll taxes for qualified small businesses. The current maximum of \$250,000 for up to five years would be increased by an additional \$250,000 per year (for a new maximum of \$500,000 per year) for tax years beginning after December 31, 2021.

The JCT has estimated that the proposal will lose \$932 million over 10 years.

KPMG observation

A qualified small business (QSB) is a corporation (including an S corporation) or partnership with:

- 1) Gross receipts of less than \$5 million for the tax year, and
- 2) No gross receipts for any tax year before the five-tax-year period ending with the tax year.

Any other person may be considered a qualified small business if the person meets the requirements of (1) and (2) above, taking into account the aggregate gross receipts received in all the trades or businesses.

Under the rules for determining gross receipts for QSB purposes, there is no exception for *de minimis* gross receipts and gross receipts includes interest and dividends.

Imposition of tax on nicotine

The House bill would add an excise tax on taxable nicotine at a rate of \$50.33 per 1,810 milligrams of nicotine (and a proportionate tax at the like rate 28 on any fractional part thereof).

Taxable nicotine would be defined as any nicotine that has been extracted, concentrated, or synthesized. However, the House bill would exclude any nicotine if the manufacturer or importer thereof demonstrates to the satisfaction of the Secretary of Health and Human Services that such nicotine will be used:

- In a drug that is approved under section 505 of the Federal Food, Drug, and Cosmetic Act (FFDCA) or licensed under section 351 of the Public Health Service Act (PHSA)
- In a drug for which an investigational use exemption has been authorized under section 505(i) of the FFDCA or under section 351(a) of the PHSA, or
- In a combination product (as described in section 503(g) of the FFDCA, the constituent parts of which were approved or cleared under section 505, 510(k), or 515 of such Act.

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 House bill 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 House bill would require the Secretary to promulgate regulations to coordinate the provisions

and avoid double taxation.

If enacted in its current form, the House bill proposal would be effective for articles removed during calendar quarters beginning 180 days after the date of enactment.

The JCT has estimated that this proposal would raise approximately \$8.6 billion over a 10-year period.

KPMG observation

An excise tax is currently imposed on manufacturers and importers of specified tobacco products, including cigarettes, cigars, and other tobacco products. The addition of nicotine used in vaping to the definition of tobacco products for purposes of section 5701 would expand the application of the excise tax to a new part of the industry. Approximately 30 states, the District of Columbia, Puerto Rico, and some cities and counties currently impose tax on vapor products.

Unlike an earlier Ways and Means proposal, the proposal does not double the rate of tax on other tobacco products and would not index the tax for inflation.

Repeal employer credit for paid family and medical leave

Section 45S currently allows a credit for certain 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 House bill 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.

State and local tax implications

Significant federal tax changes can also affect state individual and corporate income taxes significantly because of the relationships between state and federal income taxes. Any individual federal change can also have substantial state-level implications for a taxpayer, depending on the degree and manner in which the states in which a taxpayer operates conform or tie to the federal change. This section of this KPMG Report discusses the implications of the proposed House bill for state corporation income taxes. It begins with a summary of some lessons learned from state responses to TCJA and the general manner in which states conform to the Code. It then examines the potential implications of specific proposed changes, with a focus on the potential international changes. It concludes with a review of the implications of the increase in the allowable individual tax deduction for state and local taxes paid ("SALT deduction") on the choices facing taxpayers with respect to the recently enacted pass-through entity taxes passed by a number of states as a "workaround" to the TCJA state and local tax deduction cap. Read a complete review and assessment of the proposed [increased SALT deduction](#).

The changes proposed in the House bill would not be as dramatic in their potential impact on state taxes as those in the TCJA, but they nonetheless warrant careful consideration by potentially affected taxpayers. The proposed corporate tax changes with state implications are primarily modifications to the international taxation contained in the TCJA. While they do not represent the wholesale changes of

TCJA, they will require careful review and monitoring, particularly in those states that currently conform in some manner to GILTI and FDII as well as any additional states that may opt in to the new regime. In addition, the increased SALT deduction could have important ramifications for taxpayers evaluating recently enacted state pass-through entity taxes.

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. While the proposed changes in the House bill are less sweeping, state responses to the TCJA can be instructive preparing for the proposed legislation.

- States may well take more than a single legislative session to fully consider and enact their responses to any change. A period of nonconformity will likely occur. States are still adjusting their responses to TCJA enacted in 2017.
- Guidance on the application of the federal changes for state purposes may likely lag even further. Some 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.
- The experience with the TCJA has taught us there would be no uniformity in whether states conform or do not conform to federal changes, and states will differ significantly 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.
- The extent to which a particular state would conform to any federal change can be expected to be heavily influenced by several state-specific factors, including (1) general state conformity 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 being changed.

All this suggests that taxpayers should fully expect a significant period of fluctuation and uncertainty in the state tax landscape if Congress enacts additional federal tax reforms. An entity's compliance with its state tax obligations could be magnified. Accurately assessing one's state posture in this environment would require vigilant monitoring of state legislative actions and administrative guidance, careful analysis and modeling of the enacted changes, ensuring the required data is available for compliance, and devoting sufficient time and resources to compliance obligations.

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 state tax authorities alike. 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 few 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. There are significant exceptions of which to be aware. California currently

ties to the Code as of January 1, 2015, and Texas currently conforms to the Code as of January 1, 2007.

States generally begin the computation of state corporate taxable income with federal taxable income and therefore incorporate many federal deductions for state tax purposes. Most 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 effective tax rate on GILTI and provide the beneficial rate for FDII, have become increasingly important and would continue to be consequential given the proposed changes in FDII and GILTI in the House bill.

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 (with the R&D credit being an important exception). Consequently, the proposed enactment and modification of many of the tax credits in the House bill (e.g., renewable and related green energy credits) would generally have no direct effect on state tax liabilities.

Likewise, an alternative tax or other change that does not affect the computation of federal taxable income would have no direct impact on state corporate income taxes. The proposed legislation contains two new such federal taxes: (1) a corporate minimum tax on global financial statement earnings; and (2) an excise tax on certain stock repurchases. It also continues and modifies the BEAT originally enacted as part of TCJA. As alternative taxes, they do not directly affect the computation of federal taxable income and will not have a direct impact on state corporate income taxes, unless a state takes steps to adopt a state counterpart tax. The changes to the BEAT, however, may have an indirect effect on state corporate taxes that is discussed below.

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. The proposed changes to GILTI include reducing the section 250 deduction from 50% to 28.5%, lowering 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 reduce the FDII deduction to 24.8% and to make both the GILTI and FDII deductions eligible to create a net operating loss carryforward. In addition, revisions to the BEAT regime may have an indirect effect on state corporate taxes that deserve monitoring. 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: As context for understanding the changes proposed in the House bill, under the current language of 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 for 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% 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%. 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 in the House bill would reduce the effective U.S. tax rate on GILTI to 15% (consistent with BEPS Pillar II). They also make changes that would increase the amount of CFC income treated as GILTI. First, the proposal would reduce the section 250 deduction from 50% to 28.5% of GILTI. This could have a material impact in certain states, particularly those that follow the federal approach to GILTI inclusion and allow the section 250 deduction. In rolling conformity states that automatically conform to changes to the Code and that allow a section 250 deduction related to GILTI, the proposed change would increase the state taxable income base, barring any countervailing state law change. In static conformity states, however, those states that allow a section 250 deduction would continue to use the 50% deduction amount until the state updated its conformity or otherwise changed its law. This variance among the states could create compliance difficulties for taxpayers with significant operations in a mixture of rolling and static conformity states.

On the income inclusion side, 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 current law which allows aggregating the income/losses of CFCs for a U.S. Shareholder across all jurisdictions in which the CFCs operate. Both changes would likely increase the amount of GILTI for federal purposes. The changes would affect the state income tax base differently depending on the type of conformity each state has to the Code. States with rolling conformity that include some portion of GILTI in income would automatically conform to the federal computational changes, while states with fixed or selective conformity would not automatically conform. For fixed conformity states, GILTI would be computed under the existing rules of the TCJA until future legislation is enacted. This potential lack of conformity to the federal GILTI changes would create at least two different GILTI computations for state tax purposes (one using TCJA provisions and the other using the amended GILTI provisions). While these changes would add to the compliance burden for taxpayers in some cases, they could also present opportunities as long as the TCJA rules that may remain in place 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 under current law. 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 under current law 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 reduce the deduction to 24.8% of amounts deemed FDII (. This would produce an effective on FDII of about 16.,3%. 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 House bill, if the section 250 deduction with respect to GILTI and 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. 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 federal BEAT liability. This technique, however, can result in increased state taxable income. The proposed legislation would likely continue to have minimal direct impact on states, 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 state taxable income and associated state liabilities for these taxpayers.

Restrictions on deductibility of interest for an International Financial Reporting Group: In addition to maintaining the TCJA changes to section 163(j), the House bill provides for new limitations on the deductibility of interest expense under proposed section 163(n). Under the House bill, 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 House bill 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 imposes the lower limitation. Importantly, proposed new section 163(o) of the proposal allows a carryover of the interest expense disallowed under section 163(j) or section 163(n)(1). Under the House proposal, carryforwards of disallowed interest expense would be allowed to be carried forward indefinitely, as is currently allowed for section 163(j) carryforwards.

For state corporate income tax purposes, the application of section 163(j) is complicated by differences between state and federal filing methods. For federal purposes, the section 163(j) limitation is computed on a consolidated group basis. 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. A key consideration for taxpayers is whether a state requires or allows a single section 163(j) limitation (as is the case for federal income tax purposes), or whether it requires computation on a separate entity basis.

Furthermore, to the extent that a taxpayer could be subject to the limitations in both section 163(j) and section 163(n) could create further uncertainty and complexity. For example, if a state adopts both provisions, the provision under which the taxpayer's interest deduction could be limited may be different for state purposes due to the applicable state limitation being computed on a separate entity or combined group basis. Finally, 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 interest disallowed at the federal level due to section 163(j). There may also be complications to the extent a state adopts 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.

Increase in allowable individual deduction for state and local taxes: The House bill increases the amount permitted as an itemized deduction for state and local taxes, including real property and income (or sales) taxes (SALT deduction), to \$80,000 (\$40,000 in the case of an estate, trust, or married individual filing a separate return) for tax years beginning after December 31, 2020, and before January 1, 2031. Under the proposal, the SALT deduction reverts to current law (\$10,000 (\$5,000 in the case of an estate, trust, or married individual filing a separate return)) for tax years beginning after December 31, 2030, and before January 1, 2032. The current SALT deduction was contained in the TCJA and is scheduled to apply for tax years beginning before January 1, 2026.

Since establishment of the current SALT limitation in TCJA, various states have enacted "workaround" plans to facilitate a deduction for individual, trust, and estate taxpayers that is not subject to the federal limitation, while keeping the overall amount of state taxes collected by such states at a consistent level. One type of plan adopted by states is the elective state pass-through entity tax "workaround plan." Under this type of workaround, a pass-through entity agrees to become subject to an additional

state income tax expense, while the state agrees to give a benefit to the owners of the pass-through entity, which effectively compensates (fully or partially) for the pass-through entity's additional tax expense by providing the owners with state tax credits or deductions from their individual state tax. The list of states that have enacted an elective pass-through entity "workaround" has grown since Notice 2020-75 was issued by the Internal Revenue Service in November 2020. The Notice indicated that an elective pass-through entity tax could produce a deduction for SALT taxes that would be respected by the IRS "without regard to whether the imposition of and liability for the income tax is the result of an election by the entity or whether the partners or shareholders receive a partial or full deduction, exclusion, credit, or other tax benefit that is based on their share of the amount paid by the partnership or S corporation to satisfy its income tax liability under the Domestic Jurisdiction's tax law and which reduces the partners' or shareholders' own individual income tax liabilities under the Domestic Jurisdiction's tax law."

For the tax years to which the increase in the deduction limitation level for SALT taxes would apply under the House bill, there may be both direct and indirect effects on the elective pass-through entity state workaround. The effective tax years for various pass-through entity plans are tied to the tax years for which there is a limitation on individual deductions under section 164(b)(6). The extension of this limitation to apply for additional tax years would directly result in an extended life for the pass-through entity taxes that connect to the existence of a federal limitation on the SALT deduction.

The increased SALT deduction allowed under the proposal could also indirectly affect the number of pass-through entities that may participate in the workaround. The pass-through entity tax workarounds enacted since TCJA have generally been adopted as elective plans that permit qualifying pass-through entities to elect to become subject to the pass-through entity tax. An increase in the amount of SALT deduction allowed to specified owners, such as contained in the House bill, may mean that certain pass-through entities and their owners will determine that there is no longer a sufficient benefit to electing into the workaround. The due date for making the election to participate in the pass-through entity tax workaround has already passed in some states. As these elections are generally irrevocable, some pass-through entities may be bound to file the pass-through entity tax for tax year 2021, with a corresponding impact on the owners, even if the owners will not realize an additional federal income tax benefit from income taxes paid at the pass-through entity level.

Closing thoughts

If enacted, the House bill 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. In addition, the proposed changes in the SALT deduction would require taxpayers to evaluate carefully any potential participation in recently enacted pass-through entity SALT workarounds. Changes in the SALT deduction may also cause states to re-evaluate their SALT workarounds or the adoption of any further such arrangements.

Impact of proposals on accounting for income taxes

The proposals included in the House bill 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 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 included in the House bill proposals but is not all inclusive.

Changes in tax laws

Subsequent to the adoption of ASU 2019-12, *Simplifying the Accounting for Income Taxes*, the tax effect of changes in tax laws 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 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, 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 on the measurement of deferred tax assets (liabilities), including the reevaluation of a valuation allowance for deferred tax assets, 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 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

The proposal does not include a change to the standard corporate income tax rate; accordingly, for many entities, the most significant change to deferred taxes may be adjustments to the valuation allowance as noted in the observations below.

Even though deferred taxes are not generally determined on a daily basis, reasonable effort should be made to estimate temporary differences and the related deferred tax amounts, including valuation allowances, at the enactment date as part of establishing the amount of adjustment to allocate to continuing operations.

While the adjustments to deferred taxes as a result of changes in tax laws 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 deferred taxes are used in determining the discrete amount. We believe an entity may determine the discrete amount associated with ordinary income items based on the deferred taxes 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. Entities should disclose a description of the accounting policy for releasing income tax effects from accumulated other comprehensive income.

Corporate alternative minimum tax

The proposal includes a new corporate alternative minimum tax (AMT) of 15% on adjusted financial statement income (AFSI) for applicable corporations. Applicable corporations include U.S. parented corporations with a three-year average annual AFSI in excess of \$1 billion, amongst other requirements. Foreign-parented corporations are also considered applicable corporations if they similarly have a three year average annual AFSI in excess of \$1 billion with an additional requirement, in the same period, of an average of \$100 million of AFSI for the U.S. Group (including CFCs), amongst other requirements. Under the proposal, an applicable corporation's minimum tax would be equal to the amount by which the tentative minimum tax (15% of AFSI) exceeds the corporation's regular tax for the year. AFSI is the net income or loss of the taxpayer stated on the taxpayers' applicable financial statement with certain modifications. Generally, an applicable financial statement is a corporation's form 10-K filed with the Securities and Exchange Commission (SEC), an audited financial statement, or other similar financial statement.

The tentative minimum tax may be reduced by a corporate AMT foreign tax credit, which applies for foreign income taxes that are paid or accrued (for federal income tax purposes) and taken into account on an applicable financial statement. Additionally, general business credits may offset up to approximately 75% of the sum of a corporation's normal tax and alternative minimum tax.

Under the proposal, a taxpayer would be allowed to claim a credit for AMT paid against regular tax in future years, but the credit could not reduce that future year's tax liability below the computed minimum tax for that year.

KPMG observation

ASC 740 states that the applicable tax rate used in the measurement of deferred taxes should be based on the regular tax system, not the AMT system on the premise that no one can predict whether an entity will always be an AMT taxpayer and it would be counterintuitive if the addition of AMT tax provisions to the tax law were to have the effect of reducing the amount of an entity's income tax expense for financial reporting. It may also be counterintuitive to assume that an entity would permit its AMT credit carryforward to expire unused. As such, similar to the U.S. AMT system prior to the TCJA, it is generally expected that taxes paid under the new AMT system will be recognized in the determination of current tax expense (benefit), and a deferred tax asset will be recognized for any AMT incurred. The deferred tax asset should be evaluated in the same manner as other deferred tax assets using the more-likely-than-not criterion to determine whether a valuation allowance should be recognized.

Notwithstanding the counterintuitive nature of an assumption that an entity would permit its AMT credit carryforward to expire unused, an entity may still need to assess whether it expects to always be an AMT taxpayer. If an entity expects to always be an AMT taxpayer, it may not realize

the entire amount of tax benefits of its deferred tax assets under the regular tax system. For example, a temporary difference under the regular tax system may reduce future taxable income under the regular tax system but will not reduce future taxable income under the alternative minimum tax system and may result in little or no tax benefit. Accordingly, one approach would be for an entity to consider the effect of its AMT status, including whether it expects to always be an AMT taxpayer, in determining the valuation allowance for its U.S. federal deferred tax assets under the regular tax system beginning in the period the proposal is enacted.

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 15% by reducing the section 250 deduction with respect to GILTI to 28.5%. 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 TCJA. In one of the Staff Q&As, the FASB staff noted that ASC 740 is not clear as it relates to the accounting for GILTI and established that entities can apply a policy election to either provide deferred taxes related to GILTI or account for taxes on GILTI as a period cost when incurred.

KPMG observation

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 repeal the limitation on foreign tax credit carryforwards for GILTI category income and permits the carryforward of excess foreign tax credits for GILTI to the five succeeding tax years until December 31, 2030 when foreign tax credits may carry forward for 10 years. The carryback of foreign tax

credits is proposed to be repealed in all instances.

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 existing foreign tax credit carryforwards to assess which country basket they should be allocated and if sufficient taxable income of the appropriate character would be available to utilize both the existing foreign tax credit carryforwards and deferred tax assets for the federal effect of foreign deferred tax liabilities. 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, 2023, 12.5% in tax years beginning after December 31, 2022 and before January 1, 2024, 15% in tax years beginning after December 31, 2023 and before January 1, 2025 and 18% in tax years beginning after December 31, 2024.

Additionally, the proposal would provide the base erosion minimum tax amount is to be determined by taking into account tax credits, adjust the determination of modified taxable income, and provide for exceptions for certain payments as well as limit the applicability of the exception for taxpayers with a low base erosion percentage.

KPMG observation

Consistent with the FASB staff Q&A released after enactment of TCJA, entities should measure 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, interest not deductible will be carried forward indefinitely and may be treated as business interest deductions in subsequent tax years to the extent excess limitation is available. The amendments made by this section apply to tax years beginning after December 31, 2022.

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. 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. Whether, and to what extent, the changes will impact a company may depend on whether the entity evaluates future taxable income exclusive of reversing items under the with-and-without approach or the replacement approach.

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 expected group leverage ratio, 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.

If an entity is relying on both reversing taxable temporary differences and future taxable income exclusive of reversing items to realize its deferred tax assets, the impact may be effected by whether those sources of income are evaluated in combination or using an additive approach.

Excise tax on repurchase of corporate stock

The proposed legislation would impose a 1% excise tax on publicly traded U.S. corporations for the value of any of its stock that is repurchased by the corporation during the tax year, excluding certain repurchases provided specific criteria are met. The proposal applies to repurchases that arise after December 31, 2021. The amount of repurchases subject to tax is reduced by the value of any new issuance to the public and stock issued to the employees of the corporation.

KPMG observation

As the excise tax is not determined on a net income based measure, we would not expect the excise tax as proposed to be accounted for as an income tax within the scope of ASC 740. As the repurchase of shares is generally accounted for within equity, we would expect any excise tax imposed to also be recognized directly in equity as a direct cost of the transaction.

Other considerations

Additional changes included within the proposal may impact an entity's accounting for income taxes. The proposal would repeal the one-month deferral in the determination of the tax year of specified foreign corporations. 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 24.8% resulting in an approximately 15.8% effective tax rate. Further, the proposals defer the date from which research and experimental expenditures would need to be capitalized and amortized to tax years beginning after December 31, 2025 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 the tax year-end of specified foreign corporations, 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 proposed 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 grants.

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) for changes in tax laws 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 TCJA in 2017, the SEC staff released Staff Accounting Bulletin No. 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 TCJA and the FASB issued ASU 2018-02, *Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income*, subsequent to enactment covering various matters. At this point, it is not clear whether any additional guidance or further clarification on the application of accounting literature to changes in tax laws 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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