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Tax Provisions in Administration's FY 2016 Budget Proposals

International

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HIGHLIGHTS OF INTERNATIONAL TAX PROVISIONS IN THE ADMINISTRATION'S FISCAL YEAR 2016 BUDGET

KPMG has prepared a 111-page **book** that summarizes and makes observations about the revenue proposals in the Administration's FY 2016 budget. For ease of reference, we have compiled our summaries and observations relating to certain specific industries and topics in separate booklets. This booklet highlights revenue proposals that have particular application to multinational businesses. Other booklets will address proposals relating to the following topics:

- General Corporate Tax
- Tax Accounting
- Business Tax Credits
- Financial Institutions & Products
- Passthrough Entities
- Practice, Procedures, & Administration
- Charitable Deductions & Exempt Organizations
- Compensation, Benefits, & Qualified Plans
- Energy & Natural Resources
- Insurance
- Real Estate
- Taxation of Individuals

Background

On February 2, 2015, President Obama transmitted to Congress the administration's recommendations to Congress for spending and taxation for the fiscal year that begins on October 1, 2015 (i.e., FY 2016).

Among other things, the president proposed a six-year $478 billion program for transportation infrastructure, the cost of which would be offset in part by a one-time tax on the unrepatriated foreign earnings of U.S. multinational corporations. This tax would be part of a transition to a proposed fundamental change in the taxation of the future foreign earnings of U.S. corporations that would effectively eliminate deferral of tax on foreign earnings, causing them generally to be taxed on a current basis at a reduced rate. This proposed change is addressed later in this booklet.

The president also proposed a reserve for business tax reform, but not one of sufficient magnitude for significant rate reduction. The president has called for reducing the corporate income tax rate to 28%, but the budget does not provide revenue to offset the cost of such a reduction. Instead, the budget refers only to eliminating tax expenditures, such as accelerated depreciation and "reducing the tax preference for debt financed investment."

Many of the "general" business tax proposals in the FY 2016 budget are familiar, having been included in previous budgets. These proposals include, for example:

• Repeal of natural resources production preferences
• Repeal of LIFO and LCM accounting
• Taxation of carried interests in partnerships as ordinary income
• Insurance industry reforms
• Mark-to-market of financial derivatives
• Modification of the like-kind exchange rules
• Modification of the depreciation rules for corporate aircraft
• Denying a deduction for punitive damages
• Make permanent and reform the credit for research and experimentation

The president also re-proposed a tax on the liabilities of financial institutions with assets in excess of $50 billion. The rate would be reduced relative to the prior proposal from 17 basis points to 7 basis points, but the base of the tax would be different and the application of the tax would be significantly broadened to include insurance companies, savings and loan holding companies, exchanges, asset managers, broker-dealers, specialty finance corporations, and financial captives. These changes have roughly doubled the revenue raised relative to the proposal in the FY 2015 budget and are described in more detail later in this booklet.

The budget also includes a host of proposed changes to the individual income tax system. These include increasing the highest tax on capital gains from 23.8% (including the 3.8% net investment income tax) to 28%. In addition, a transfer of appreciated property would generally be treated as a sale of the property, subject to various exceptions and exclusions. For example, relief would be provided to lessen the immediate impact of the proposed change on the transfers of small businesses.

International Tax Proposals

This booklet addresses the following budget proposals.

Reforms

Impose a 19% minimum tax on foreign income

The administration's FY 2016 budget includes a new proposal that would supplement the existing subpart F regime with a new per-country minimum tax on foreign earnings of U.S. corporations and controlled foreign corporations (CFCs). The minimum tax would apply to a U.S. corporation that is a U.S. shareholder of a CFC or that has foreign earnings from a branch or from the performance of services outside the United States. Under the proposal, a foreign branch of a U.S. corporation would be treated like a CFC. The foreign earnings subject to the proposal would be subject to current U.S. taxation at a rate of 19% less 85% of the per-country foreign effective tax rate (the "residual minimum tax rate").

The foreign effective tax rate would be computed on an aggregate basis with respect to all foreign earnings and the associated foreign taxes assigned to a country for the 60-month period that ends on the last day of the domestic corporation's or CFC's tax year, as applicable. For this purpose, the foreign taxes taken into account are those taxes that generally would be eligible to be claimed as a foreign tax credit during the 60-month period. The foreign earnings taken into account for the 60-month period generally would be determined under U.S. tax principles but would include disregarded payments deductible elsewhere, such as interest or royalty payments among related CFCs, and would exclude dividends from related parties.

The country to which a CFC's foreign earnings and associated foreign taxes are assigned is based on the CFC's tax residence under foreign law, but the earnings and taxes of a particular CFC may be allocated to multiple countries if the earnings are subject to tax in multiple countries. If the same earnings of a CFC are subject to tax in multiple countries, the earnings and all of the foreign taxes associated with those earnings would be assigned to the highest-tax country.

The minimum tax for a particular country would be computed by multiplying the applicable residual minimum tax rate by the minimum tax base for that country. A U.S. corporation's minimum tax base for a country for a tax year would be the total amount of foreign earnings for the tax year assigned to that country, reduced by an allowance for corporate equity (ACE). The ACE provision would provide a risk-free return on equity invested in active assets and is intended to exempt from the minimum tax a return on the actual activities undertaken in a foreign country.

For purposes of determining the foreign effective tax rate and the minimum tax base for a particular year, the proposal would include special rules to restrict the use of hybrid arrangements to shift earnings from a low-tax country to a high-tax country for U.S. tax purposes without triggering tax in the high-tax country. For example, no deduction would be recognized for a payment from a low-tax country to a high-tax country that would be treated as a dividend eligible for a participation exemption in the high-tax country. In addition, the earnings assigned to a low-tax country would be increased for a dividend payment from a high-tax country that is treated as deductible in the high-tax country.

The minimum tax would be imposed on current earnings regardless of whether they are repatriated to the United States. The subpart F regime generally would continue to require a U.S. shareholder of a CFC to currently include in gross income its pro rata share of the CFC's subpart F income, but the proposal would make several modifications to the existing subpart F rules as applied to U.S. corporate shareholders, including: (1) making the subpart F "high-tax" exception mandatory; (2) repealing rules regarding CFC investments in U.S. property; and (3) repealing rules regarding previously taxed earnings.

Additionally, a U.S. shareholder would not be subject to U.S. tax on gain on the sale of CFC stock to the extent the gain is attributable to the CFC's undistributed earnings. However, any gain in the stock that is attributable to unrealized gain in the CFC's assets would be subject to U.S. tax in the same manner as the future earnings from those assets (i.e., stock gain would be subject to the minimum tax or to the full U.S. rate to the extent the assets that would generate earnings are subject to the minimum tax or subpart F, respectively).

The proposal also would modify the foreign tax credit rules to prevent a U.S. corporate shareholder from offsetting its U.S. tax liability on low-taxed foreign income with foreign taxes attributable to earnings of a high-taxed CFC that were exempt from U.S. taxation.

Interest expense incurred by a U.S. corporation that is allocated and apportioned to foreign earnings on which the minimum tax is paid would be deductible at the residual minimum tax rate applicable to those earnings. No deduction would be permitted for interest expense allocated and apportioned to foreign earnings for which no U.S. income tax is paid.

The Secretary would be granted authority to issue regulations to carry out the purposes of the minimum tax, including regulations addressing the taxation of undistributed earnings when a U.S. corporation owns an interest in a foreign corporation that has a change in CFC status, and regulations to prevent the avoidance of the minimum tax through outbound transfers of built-in-gain assets or CFC stock.

The proposal would be effective for tax years beginning after December 31, 2015.

Impose a 14% one-time tax on previously untaxed foreign income

The administration's FY 2016 budget includes a new proposal that would impose a one-time 14% tax on a CFC's accumulated earnings that were not previously subject to U.S. tax. A credit would be allowed for the amount of foreign taxes associated with such untaxed earnings multiplied by the ratio of the one-time tax rate to the maximum U.S. corporate rate for 2015. Any untaxed CFC earnings subject to this one-time tax could then be repatriated without any additional U.S. tax liability. The tax due under this proposal would be payable ratably over five years. This proposal would be effective on the date of enactment and would apply to earnings accumulated for tax years beginning before January 1, 2016.

KPMG observation

The computational details of this proposal have not been provided. For example, it is not clear whether or to what extent deficits in one CFC might offset earnings in another CFC for this purpose, or how the taxes paid by a CFC will be taken into account if the CFC has a deficit in earnings and profits.

Restrict deductions for excessive interest of members of financial reporting groups

The administration's FY 2016 proposal to restrict deductions for excessive interest of members of financial reporting groups is substantially similar to the provision included in the administration's FY 2015 budget, except it would be effective for tax years beginning after December 31, 2015. Additionally, when a U.S. member of a U.S. subgroup owns stock of one or more foreign corporations, this proposal would apply before the administration's minimum tax proposal discussed above.

KPMG observation

Unlike the proposals discussed above, which are focused primarily on the foreign activities of U.S. multinationals, this proposal appears principally intended to limit foreign-owned multinationals from disproportionately claiming interest expense against their U.S. income tax liability as compared to their tax liabilities elsewhere in the world.

Close loopholes under subpart F

The administration's FY 2016 proposals to create a new category of subpart F income for digital income and to expand the foreign base company sales income rules to include income related to manufacturing services arrangements are substantially similar to provisions in the administration's FY 2015 budget, except that they would be effective for tax years beginning after December 31, 2015.

The administration's FY 2016 proposal includes two new provisions that would modify the thresholds for applying subpart F in two ways. First, for purposes of determining whether a foreign corporation is a CFC and a U.S. person is a U.S. shareholder of a CFC, the proposal would amend the ownership attribution rules of section 958(b) to attribute stock of a foreign corporation from a foreign person to a related U.S. person. However, the pro rata share of a CFC's subpart F income that a U.S. shareholder is required to include in gross income would continue to be determined based on direct or indirect ownership of the CFC, without application of section 958(b).

Second, the administration's proposal would eliminate the requirement for a foreign corporation to be a CFC for an uninterrupted period of at least 30 days in order for a U.S. shareholder to be required to include in gross income its pro rata share of the CFC's subpart F income.

Both proposals would be effective for tax years beginning after December 31, 2015.

Repeal delay in the implementation of worldwide interest allocation

The administration's FY 2016 budget includes a new proposal that would accelerate the availability of the worldwide affiliated group election for allocating interest expense to tax years beginning after December 31, 2015. The Treasury Department's general explanation of the tax proposals of the budget—the so-called "**Green Book**"—states that accelerating the availability of the election would allow taxpayers to more accurately allocate and apportion interest expense for all purposes for which the allocation is relevant, including for implementing the new minimum tax proposal discussed below.

Limit shifting of income through intangible property transfers

The administration's FY 2016 proposal to limit shifting of income through intangible property transfers is substantially similar to the provision included in the administration's FY 2015 budget, except it would be effective for tax years beginning after December 31, 2015.

Disallow the deduction for excess non-taxed reinsurance premiums paid to affiliates

The administration's FY 2016 proposal would: (1) deny an insurance company a deduction for reinsurance premiums for property and casualty risks paid to affiliated foreign reinsurance companies to the extent that the foreign reinsurer (or its parent company) is not subject to U.S. income tax with respect to the premiums received; and (2) exclude from the insurance company's income (in the same proportion that the premium deduction was denied) any ceding commissions received or reinsurance recovered with respect to reinsurance policies for which a premium deduction is wholly or partially denied.

A foreign corporation that receives a premium from an affiliate that would otherwise be denied a deduction under this proposal would be permitted to elect to treat the premium and the associated investment income as income effectively connected with the conduct of a trade or business in the United States, and attributable to a permanent establishment for tax treaty purposes.

For foreign tax credit purposes, reinsurance income that is treated as effectively connected under this rule would be treated as foreign source income and would be placed into a separate category within section 904.

The provision would be effective for policies issued in tax years beginning after December 31, 2015.

KPMG observation

Similar proposals have been made in the last four budget proposals. The FY 2016 proposal, like the FY 2015 proposal, would limit the disallowance to property and casualty reinsurance premiums, making it consistent with the *Tax Reform Act of 2014* proposed by the former Chairman of the House Ways and Means Committee, Dave Camp, in the last congress.

Modify tax rules for dual capacity taxpayers

The administration's FY 2016 proposal to modify the tax rules for dual-capacity taxpayers is substantially similar to the provision included in the administration's FY 2015 budget, except it generally would be effective for tax years beginning after December 31, 2015.

KPMG observation

It is not clear how the dual capacity taxpayer proposal interacts with the minimum tax proposal. Note, however, that the revenue estimate for the dual capacity taxpayer proposal is smaller than it was in the FY 2015 budget, suggesting that there could be an interaction effect between the minimum tax proposal and the dual capacity taxpayer proposal.

Tax gain from the sale of a partnership interest on look-through basis

The administration's FY 2016 proposal to tax gain from the sale of a partnership interest as effectively connected income on a look-through basis is substantially similar to the provision included in the administration's FY 2015 budget, except it would be effective for sales or exchanges after December 31, 2015. Very generally, the proposal would provide that gain or loss from the sale or exchange of a partnership interest would be effectively connected with the conduct of a trade or business in the United States to the extent attributable to the transferor partner's distributive share of the partnership's unrealized gain or loss attributable to ECI property

Modify sections 338(h)(16) and 902 to limit credits when non-double taxation exists

The administration's FY 2016 proposal—substantially similar to the provisions included in the administration's FY 2015 budget, except it would be effective for transactions occurring after December 31, 2015—would extend the application of section 338(h)(16) to any covered asset acquisition (within the meaning of section 901(m)) and remove foreign taxes from a section 902 corporation's foreign tax pool in the event of a transaction that results in the reduction, allocation, or elimination of a foreign corporation's earnings and profits other than by reason of a dividend or a section 381 transaction.

Restrict the use of hybrid arrangements that create stateless income

The administration's FY 2016 proposal to grant the Treasury Secretary authority to issue regulations denying deductions for interest and royalty payments made to related parties under certain circumstances involving a hybrid arrangement is substantially similar to the provision in the administration's FY 2015 budget, except the FY 2016 proposal would be effective for tax years beginning after December 31, 2015.

The administration's FY 2016 proposal to make sections 954(c)(3) (the "same-country exception") and 954(c)(6) (the related CFC look-through rule) inapplicable to payments made to a foreign reverse hybrid held directly by a U.S. person when such amounts are treated as deductible payments received from foreign related persons is substantially similar to the provision in the administration's FY 2015 budget, except that the FY 2016 proposal would be effective for tax years beginning after December 31, 2015. The Administration's budget does not otherwise propose changing the application of the "check-the-box" rules on entity classification.

KPMG observation

The administration's proposals effectively would divide foreign income into three categories: (1) foreign income that is subject to current taxation at the full U.S. tax rate under subpart F; (2) non-subpart F income that is subject to current U.S. taxation under the minimum tax provision, and thus may bear an effective tax rate as high as 19%; and (3) non-subpart F income that is exempt from U.S. taxation pursuant to the ACE allowance, which could possibly be completely tax-free on a world-wide basis. The per-country minimum tax computation and the high-tax exception would operate to assign discrete blocks of income into these three categories with little opportunity for taxpayers to average tax rates on their operations (or on subpart F vs. active income) in different countries to their benefit.

The minimum tax coupled with the ACE allowance is conceptually similar to the minimum tax proposal in the Camp tax reform bill. Very generally, the Camp tax reform bill would have imposed a minimum tax of 15% on a CFC's foreign earnings by creating a new category of subpart F income (foreign base company intangible income or FBCII) for foreign earnings subject to an effective tax rate below 15%. Like the administration's ACE, the Camp tax reform bill excluded from the FBCII tax base a specified percentage (in the Camp tax reform bill, 10%) of the CFC's qualified business asset investment, which was defined by Camp as the aggregate adjusted basis of certain tangible depreciable property used in the CFC's trade or business. It is not clear how the ACE allowance would be determined under the administration's minimum tax provision.

The minimum tax proposal also includes several new concepts and raises a number of questions. For example, rather than allowing a foreign tax credit, the tentative U.S.

minimum tax of 19% would be reduced by an average tax rate computed over a 60-month period. The administration did not provide its rationale for this rolling average approach, which generally would be similar in results to a five-year carryforward (and no carryback) for foreign tax credits in a per country basket (subject to a 15% reduction).

The proposal also would amend the rules in section 1248 regarding the sale of CFC stock by certain U.S. shareholders. As discussed above, the proposal would currently tax gain in CFC stock that is attributable to unrealized gain in the CFC's assets to the extent the assets would give rise to subpart F income or income subject to the minimum tax. It is not clear, however, how this rule would apply if the U.S. shareholder acquired the CFC's stock without making a section 338(g) election, or if the gain is attributable to appreciation that occurred while the foreign corporation was not a CFC.

Inversion-related

Limit the ability of domestic entities to expatriate

The proposal would broaden the definition of an inversion transaction by replacing the 80% test in section 7874 with a greater than 50% test, and it would eliminate the 60% test. The proposal would also provide that an inversion transaction would occur—regardless of the level of shareholder continuity—if:

- Immediately prior to the transaction, the fair market value of the domestic entity's stock is greater than the fair market value of the foreign acquiring corporation's stock,
- The foreign acquiring corporation's expanded affiliated group is primarily managed and controlled in the United States, and
- The foreign acquiring corporation's expanded affiliated group does not conduct substantial business activities in the country in which the foreign acquiring corporation is created or organized.

Accordingly, an inversion transaction could occur under the proposal even if a majority of the domestic entity's historic shareholders elect to maintain their existing investments in the domestic entity and not roll into foreign acquiring corporation stock.

The proposal would also expand the scope of section 7874 to provide that an inversion transaction could occur if there is a direct or indirect acquisition of substantially all of the:

- Assets of a domestic corporation or domestic partnership,
- Trade or business assets of a domestic corporation or domestic partnership, or
- U.S. trade or business assets of a foreign partnership.

Finally, the proposal would provide the IRS with the authority to share tax return information with other federal agencies to facilitate the administration of an agency's anti-inversion rules. Other federal agencies that receive this information would be subject to the safeguarding and recordkeeping requirements of section 6103.

The proposals to limit a domestic entity's ability to expatriate would be effective for transactions completed after December 31, 2015. The proposal to allow the IRS to share tax return information with other federal agencies would be effective January 1, 2016, without regard to when the inversion occurred.

KPMG observation

The proposal is intended to limit the ability of domestic entities to expatriate. Under the proposal, the anti-inversion rules could apply if the continuing ownership of the domestic corporation's historical shareholders in the foreign acquiring corporation is more than 50%, and in such case the foreign acquiring corporation would be treated as a domestic corporation. Under the current anti-inversion rules in section 7874, the foreign acquiring corporation may be treated as a domestic corporation only if the continuing ownership is at least 80% (and in case the continuing ownership is at least 60% but less than 80%, other adverse but less severe tax consequences may apply). Thus, the proposed anti-inversion rules would be triggered at a lower threshold and with more severe consequences.

This proposed change is intended to address the fact that domestic entities have been combining with smaller foreign entities resulting in a continued ownership being less than 80% (although more than 60%). Treasury stated "[t]he adverse tax consequences under current law of 60-percent inversion transactions have not deterred taxpayers from pursuing these transactions. There is no policy reason to respect an inverted structure when the owners of a domestic entity retain a controlling interest in the group, only minimal operational changes are expected, and there is potential for substantial erosion of the U.S. tax base."

Additionally, under the proposal, a foreign corporation's acquisition of a domestic entity could be treated as an inversion—even if there is no ownership continuity—if (1) immediately prior to the transaction, the domestic entity's fair market value is greater than the foreign acquiring corporation's fair market value, and (2) the foreign acquiring corporation's expanded affiliated group (A) is primarily managed and controlled in the United States, and (B) does not conduct substantial business activities in the foreign acquiring corporation's country of creation or organization. Treasury stated that, under these circumstances, the transaction would still be considered an inversion, even if the shareholders of the domestic entity do not maintain control of the resulting multinational group.

Section 7874 currently only applies to direct or indirect acquisitions of (1) substantially all the properties directly or indirectly held by a domestic corporation, or (2) substantially all the properties constituting a trade or business of a domestic partnership. The proposed changes to the scope of acquisitions covered by section 7874 are important in several respects. First, an inversion could occur where a foreign corporation acquires substantially all of a domestic corporation's trade or business assets, even though such assets do not represent substantially all of the domestic corporation's total assets (e.g., if the domestic entity retains a significant amount of cash). Second, an inversion could occur where a foreign corporation acquires substantially all the assets of a domestic partnership regardless of whether the assets constitute a trade or business. Thus, the proposal would treat acquisitions of domestic corporations and domestic partnerships similarly, as opposed to the current section 7874 acquisition rules. Finally, an inversion could occur where a foreign corporation acquires substantially all of the U.S. trade or business assets of a foreign partnership—a clear departure from current law, which does not apply to foreign entities.

Finally, the proposal would permit the IRS to share tax return information with other federal agencies to promote any agency's anti-inversion rules. Currently, the IRS is restricted from sharing this information under section 6013.

Although not part of the inversion proposal, the proposed modifications to section 958(b) and the definition of a CFC (discussed above) could have a significant impact on foreign-parented groups that include a U.S. corporation with its own foreign subsidiaries, including companies that have successfully "inverted" in the past.

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

The administration's FY 2016 proposal would create a new general business credit against income tax equal to 20% of the eligible expenses paid or incurred in connection with insourcing a U.S. trade or business, i.e., related to reducing or eliminating a trade or business (or line of business) currently conducted outside the United States and starting up, expanding, or otherwise moving the same trade or business within the United States, to the extent that this action results in an increase in U.S. jobs. Any creditable costs incurred by a foreign subsidiary would allow a tax credit to be claimed by the U.S. parent company.

In addition, the proposal would disallow deductions for expenses paid or incurred in connection with outsourcing a U.S. trade or business, i.e., related to reducing or eliminating a trade or business or line of business currently conducted inside the United States and starting up, expanding, or otherwise moving the same trade or business outside the United States, to the extent that this action results in a loss of U.S. jobs. In determining the subpart F income of a controlled foreign company (CFC), no reduction would be allowed for any expenses associated with moving a U.S. trade or business outside the United States.

For purposes of the proposal, expenses paid or incurred in connection with insourcing or outsourcing a U.S. trade or business would be limited solely to expenses associated with the relocation of the trade or business and would not include capital expenditures or costs for severance pay and other assistance to displaced workers. The proposal would be effective for expenses paid or incurred after the date of enactment.

KPMG observation

Neither the tax credit nor the expense disallowance would apply unless there is an impact on U.S. jobs from the insourcing or outsourcing, respectively, of a U.S. trade or business. The budget proposal does not specify the required degree of such impact or ways to determine it. The proposal also does not specify the extent to which there must be a simultaneous impact on the foreign trade or business (and jobs).

Expired provisions

Make permanent the exception under subpart F for active financing income

The administration's FY 2016 budget includes a new proposal that would make permanent the temporary active financing exception to subpart F income for certain insurance, banking, financing, and similar income.

KPMG observation

Although deferral would no longer be available, by extending this exception, active financing income would benefit from the 19% reduced U.S. rate described above rather than being subjected to (28%) U.S. residual tax at the full corporate rate.

Extend the look-through treatment of payments between related controlled foreign corporations (CFCs)

The administration's FY 2016 budget includes a new proposal that would make permanent the temporary subpart F "look-through" exception for certain payments between related CFCs.

KPMG observation

Like the extension for active financing income, when taken together with the other budget proposals, this proposal would allow income to qualify for a lower U.S. rate.

Other provisions

Impose a "financial fee"

The administration proposes to impose a financial fee on financial entities. The administration cites excessive risk undertaken by major financial firms as a significant cause of the recent financial crisis and an ongoing potential risk to macroeconomic stability. The administration believes this fee will reduce the incentive for large financial institutions to leverage, reducing the cost of externalities arising from financial firm default as a result of high leverage. The structure of this fee would be broadly consistent with the principles agreed to by the G-20 leaders.[1]

The fee would apply to both U.S. and foreign banks; bank holding companies; and "nonbanks," such as insurance companies, savings and loan holding companies, exchanges, asset managers, broker-dealers, specialty finance corporations, and financial captives. Firms with worldwide consolidated assets of less than $50 billion would not be subject to the fee for periods when their assets are below this threshold. According to the Green Book, U.S. subsidiaries and branches of foreign entities that fall into these business categories and that have assets in excess of $50 billion also would be covered.

The fee would apply to the "covered liabilities" of a financial entity. Covered liabilities would be "assets less equity for banks and nonbanks based on audited financial statements with a deduction for separate accounts (primarily for insurance companies)."

The rate of the fee applied to covered liabilities would be seven basis points, and the fee would be deductible in computing corporate income tax. A financial entity subject to the fee would report it on its annual federal income tax return. Estimated payments of the fee would be made on the same schedule as estimated income tax payments.

According to the administration's estimates, the fee would raise $112 billion over 10 years and would apply to roughly 100 firms with assets over $50 billion.

The fee would be effective as of January 1, 2016.

Exempt foreign pension funds from the application of the Foreign Investment in Real Property Tax Act (FIRPTA)

The administration's FY 2016 proposal to exempt from the application of FIRPTA gains of foreign pension funds from the disposition of U.S. real property interests (USRPIs) is substantially similar to the provision included in the administration's FY 2015 budget, except I would be effective for dispositions occurring after December 31, 2015

Provide for reciprocal reporting of information in connection with the implementation of the Foreign Account Tax Compliance Act (FATCA)

Under FATCA, foreign financial institutions are required to report account balances, as well as amounts such as dividends, interest, and gross proceeds paid or credited to a U.S. account without regard to the source of such payments. To implement FATCA, the United States has established a broad network of information exchange relationships with other jurisdictions based on established international standards. The success of those information exchange relationships depends on cooperation and reciprocity. Requiring U.S. financial institutions to report to the IRS the comprehensive information

[1] *See* Staff of the International Monetary Fund, "A Fair and Substantial Contribution by the Financial Sector: Final Report for the G-20" (June 2010).

required under FATCA with respect to accounts held by certain foreign persons, or by certain passive entities with substantial foreign owners, would facilitate the intergovernmental cooperation contemplated by the intergovernmental agreements by enabling the IRS to provide equivalent levels of information to cooperative foreign governments in appropriate circumstances to support their efforts to address tax evasion by their residents.

The administration's FY 2016 proposal would require certain financial institutions to report the account balance (including, in the case of a cash value insurance contract or annuity contract, the cash value or surrender value) for all financial accounts maintained at a U.S. office and held by foreign persons. The proposal also would expand the current reporting required with respect to U.S. source income paid to accounts held by foreign persons to include similar non-U.S. source payments. In addition, the Secretary would be granted authority to issue Treasury regulations to require financial institutions to report the gross proceeds from the sale or redemption of property held in, or with respect to, a financial account, information with respect to financial accounts held by certain passive entities with substantial foreign owners, and such other information that the Secretary or his delegate determines is necessary to carry out the purposes of the proposal. Finally, the proposal would require financial institutions that are required by FATCA or this proposal to report to the IRS information with respect to financial accounts to furnish a copy of the information to the account holders.

The proposal would be effective for returns required to be filed after December 31, 2016.

KPMG observation

This proposal could result in a significant increase in costs and burdens on U.S. businesses with respect to the proposed expansion of reporting. The addition requiring the furnishing of information to account holders is new to this proposal in 2016 and could further exacerbate these costs and burdens.

This provision was included in the administration's FY 2015 revenue proposal.

Extend partnership basis limitation rules to nondeductible expenditures

Under current law, a partner's distributive share of partnership losses for a tax year is allowed only to the extent of the partner's adjusted basis in its partnership interest at the end of the partnership tax year. Losses that are disallowed under this rule generally are carried forward and are allowed as deductions in future tax years to the extent the partner has sufficient basis at such time. The IRS issued a private letter ruling in 1984 concluding that this loss limitation rule does not apply to limit a partner's deduction for its share of the partnership's charitable contributions.

As was the case for the previous fiscal year's budget proposal, the administration's FY 2016 proposal would modify the statutory loss limitation rule to provide that a partner's distributive share of expenditures not deductible by the partnership (or chargeable to capital account) are allowed only to the extent of the partner's adjusted basis in the partnership interest at the end of the year.

A JCT explanation of a substantially similar budget proposal for FY 2013 indicates that the current loss limitation rule is intended to limit a taxpayer's deductions to its investment in the partnership (taking into account its share of partnership debt). The JCT explanation suggests that the administration's proposal is intended to address the following concern:

> Because of a technical flaw in the statute, which was written in 1954, it appears that the limitation does not apply, for example, to charitable contributions and foreign taxes of the partnership, because those items are not deductible in computing partnership income. Because a partner's basis cannot be decreased below zero, a partner with no basis is allowed a deduction (or credit) for these items without having to make the corresponding reduction in the basis of his partnership interest that would otherwise be required.

The provision would apply to partnership tax years beginning on or after the date of enactment.

Limit the importation of losses under related party loss limitation rules

Generally, a loss cannot be recognized if it is from a sale or exchange of property between either certain related persons, including an individual and a more-than-50% owned corporation or partnership, or two corporations or partnerships in which the individual has a more-than-50% ownership. However, section 267(d) allows the transferee to apply that loss against any gain on a later disposition of the transferred asset.

The administration's FY 2016 proposal would amend section 267(d) so that the transferee could not apply such a loss to the later transaction to the extent that gain or loss with respect to such property is not subject to U.S. federal income tax in the hands of the transferor immediately before the transfer, but any gain or loss with respect to such property is subject to U.S. federal income tax in the hands of the transferee immediately after the transfer. This would appear to apply, among other situations, when the transferor is a foreign person not subject to U.S. federal income tax and the related transferee is a person subject to U.S. federal income tax.

The provision would apply to transfers made after the date of enactment.

KPMG observation

This proposal also appeared in the administration's FY 2013, FY 2014, and FY 2015 proposals. It represents a continuing effort to police the importation of built-in losses. The Joint Committee of Taxation's description of this provision in the administration's

FY 2013 proposal notes that it "addresses certain transactions in which a taxpayer might utilize a sale or exchange that does not qualify as a tax free organization or reorganization to accomplish a loss importation result, under similar circumstances with respect to the taxation or nontaxation of gain or loss as are addressed in section 362(e)(1)."

Conform corporate ownership standards

The administration's FY 2016 proposal would amend the "control test" under section 368 to adopt the "affiliation test" under section 1504. Thus, "control" would be defined as the ownership of at least 80% of the total voting power and at least 80% of the total value of stock of a corporation. For this purpose, stock would not include certain preferred stock that meets the requirements of section 1504(a)(4) (certain non-voting, "plain vanilla" preferred stock).

Currently, for tax-free transfers of assets to controlled corporations in exchange for stock, tax-free distributions of controlled corporations, and tax-free corporate reorganizations, "control" is defined in section 368 as the ownership of 80% of the voting stock and 80% of the number of shares of all other classes of stock of the corporation. In contrast, the "affiliation test" under section 1504 for permitting two or more corporations to file consolidated returns is the direct or indirect ownership by a parent corporation of at least 80% of the total voting power of another corporation's stock and at least 80% of the total value of the corporation's stock (excluding certain plain vanilla preferred stock). Several other Code provisions cross-reference and incorporate either the control test or the affiliation test.

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

The proposal would be effective for transactions occurring after December 31, 2015.

KPMG observation

This proposal is consistent with previous changes made to the affiliation test. For example, as noted in the proposal, prior to 1984, the affiliation test required ownership of 80% of the voting stock and 80% of the number of shares of all other classes of stock of the corporation, similar to the control test in section 368. Congress amended the affiliation test in 1984 in response to similar concerns that corporations were filing consolidated returns under circumstances in which a parent corporation's interest in the issuing corporation was being manipulated.

Tax corporate distributions as dividends

The administration's FY 2016 proposal would make several changes to the tax treatment of certain distributions of property by a corporation to its shareholder which, under current law, may not give rise to dividend income. The proposal explains that transactions of this type reduce a corporation's earnings and profits but do not result in a reduction in a corporation's dividend paying capacity, and are therefore inconsistent with a corporate tax regime in which earnings and profits are viewed as measuring a corporation's dividend-paying capacity. The FY 2016 proposal targets three transactions previously identified in prior proposals and additionally includes purchases of hook stock by a corporate subsidiary. As indicated below, one aspect of the proposal addresses leveraged distributions from related foreign corporations.

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

Similar to the administration's FY 2015 proposal, the FY 2016 proposal would treat a leveraged distribution from a corporation to its shareholders that is treated as a recovery of basis as the receipt of a dividend directly from a related corporation to the extent the funding corporation funded the distribution with a principal purpose of not treating the distribution as a dividend from the funding corporation. This proposal revises a previous proposal to disregard a shareholder's basis in the stock of a distributing corporation for purposes of recovering such basis under section 301(c)(2).

This proposal would be effective for transactions occurring after December 31, 2015.

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

Generally, a corporation is required to recognize any gain realized on the distribution of any appreciated property to a shareholder, but does not recognize any loss realized on the distribution of property with respect to its stock. Although the corporation does not recognize a loss, its earnings and profits (E&P) are decreased by the sum of the amount of money, the principal amount or issue price of any obligations (as the case may be), and the adjusted basis of any other property distributed. Additionally, if an actual or deemed redemption of stock is treated under section 302 as equivalent to the receipt of a dividend by a shareholder, the shareholder's basis in any remaining stock of the corporation is increased by the shareholder's basis in the redeemed stock.

Similar to the administration's FY 2015 proposal, the FY 2016 proposal would amend section 312(a)(3) to provide that E&P are reduced by the basis in any distributed high-basis stock determined without regard to basis adjustments resulting from actual or deemed dividend equivalent redemptions or any series of distributions or transactions undertaken with a view to create and distribute high-basis stock of any corporation.

The proposal would be effective on the date of enactment.

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

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

The administration's FY 2016 proposal would disregard a subsidiary's purchase of hook stock for property so that the property used to purchase the hook stock gives rise to a deemed distribution from the purchasing subsidiary (through any intervening entity) to the issuing corporation. The hook stock would be treated as being contributed by the issuer (through any intervening entities) to the subsidiary. The proposal would also grant the Secretary authority to prescribe regulations to treat purchases of interest in shareholder entities other than corporations in a similar manner and provide rules related to hook stock within a consolidated group.

The proposal would be effective for transactions occurring after December 31, 2015.

Repeal gain limitation for dividends received in reorganization exchanges

Section 356(a)(1) currently provides that if, as part of a reorganization, a shareholder receives stock and boot in exchange for its stock in the target corporation, then the shareholder recognizes gain, but not in excess of the boot (the so-called "boot within gain" limitation). Under section 356(a)(2), if the exchange has the effect of the distribution of a dividend, then all or part of the gain recognized by the shareholder is treated as a dividend to the extent of the shareholder's ratable share of the corporation's E&P, with the remainder of the gain treated as gain from the exchange of property (generally capital gain).

Similar to the administration's FY 2011 through FY 2015 proposals, the administration's FY 2016 proposal would repeal the "boot within gain" limitation in the case of any reorganization if the exchange has the effect of the distribution of a dividend under section 356(a)(2). In addition, the FY 2016 proposal would align the available pool of E&P to test for dividend treatment with the rules of section 316 governing ordinary distributions.

The proposal would be effective for transactions occurring after December 31, 2015.

Repeal non-qualified preferred stock (NQPS) designation

The administration's FY 2016 proposal would remove from the Code the designation NQPS and the treatment of such stock as "boot."

Section 351(g) excepts from the general nonrecognition rule of section 351 transfers of property to a corporation in exchange for NQPS of that corporation. NQPS is stock that: (1) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent; and (2) has a dividend rate that varies with reference to an index, or in certain circumstances, a put right, call right, or a mandatory redemption feature. NQPS also may be treated as boot if it is received in certain shareholder exchanges pursuant to a plan of reorganization.

The proposal notes that NQPS commonly is used in corporate tax planning in a variety of ways. For example, the transfer of an asset with a built-in loss to a controlled corporation in exchange for NQPS of that corporation generally allows the transferor to recognize the loss (subject to loss limitation rules such as section 267) and to avoid the general nonrecognition rule of section 351. In addition, the use of NQPS to acquire stock of a related party may help avoid deemed dividend treatment that might otherwise result from a related-party stock purchase under section 304.

In enacting the NQPS provisions in 1997, Congress recognized that certain types of preferred stock more appropriately represented taxable consideration because the transferor obtained a more secure form of investment. The administration's FY 2016 proposal embodies a belief that transactions such as those described above may be either inconsistent with Congress's original intent in enacting the provision and/or may otherwise add unnecessary complexity.

The proposal would repeal the NQPS provision in section 351 (and any other cross-referencing provision of the Code) for stock issued after December 31, 2015.

KPMG observation

The administration's FY 2012 through FY 2015 proposals had similar provisions. The reference in the proposal to the use of NQPS in related-party stock sales to avoid deemed dividend treatment is interesting in light of the fact that all stock (whether NQPS or otherwise) is not "property" for purposes of section 304. Thus, it would seem that any stock (regardless of its classification as NQPS or otherwise) may be used to avoid section 304. However, if this change is enacted, NQPS no longer could be used to avoid both section 304 deemed dividend treatment and section 351 nonrecognition treatment with respect to the same transfer if section 351 would be applicable. Thus, the proposal, if enacted, still would limit tax planning opportunities (as well as protect taxpayers from inadvertently planning into a taxable exchange) related to the use of NQPS in related-party stock sales.

Streamline audit and adjustment procedures for large partnerships

The IRS encounters many auditing and adjustment problems for partnerships that have a large number of partners. The *Tax Equity and Fiscal Responsibility Act of 1982* (TEFRA) established certain rules applicable to all but certain small partnerships. The purpose of the TEFRA partnership rules is to provide consistent treatment of partnership items among all partners on both partnership returns and partnership audits, and to lessen the administrative and judicial burdens placed on the government. The Tax Relief Act of 1997 established a second streamlined audit and adjustment procedure for a large partnership, as well as a simplified reporting system for partnerships that have 100 or more partners during the preceding tax year and that elect to be treated as an electing large partnership (ELP).

According to the Green Book, the present TEFRA partnership procedures remain inefficient and more complex than those applicable to other large entities. Further, few large partnerships have elected into the ELP regime, which was intended to mitigate the problems associated with large partnerships.

The administration's FY 2016 proposal would repeal the existing TEFRA and ELP procedures and create new simplified partnership procedures (SPP) for any partnership that has 100 or more direct partners in the aggregate during the tax year of the adjustment or has any one partner that is a pass-through partner, i.e., another partnership, estate, trust S corporation, nominee or similar person. A partnership subject to the SPP regime, because it has a passthrough partner, may elect out of the SPP regime if it can demonstrate that it has fewer than 100 direct and indirect partners in the aggregate in the year of the proposed adjustment.

The IRS would audit the partnership (source partnership) and make adjustments at the partnership level that flow to the partners who held interests in the year of the adjustments. Any additional tax due would be assessed in accordance with the direct partner's ownership interest for that year, and any direct partner that is a passthrough partner would be required to pay the tax for its members. Passthrough partners would have 180 days to challenge the assessment based on the tax attributes of its direct and indirect partners for the year to which the adjustments are made.

Unlike the TEFRA rules, the SPP would allow only the partnership to request a refund and partners would have no right to participate in the partnership level proceedings. The IRS would not be required to give notice to partners of the partnership audit or the final partnership adjustment. The IRS would be required to give notice only to the source partnership, and only the source partnership through an authorized person, a U.S. individual identified on the partnership return, could participate in the examination. If the partnership fails to make a designation, the IRS would make the designation of the authorized person.

Similar to TEFRA, the SPP require partners to report partnership items consistent with the partnership, and failure to notify the IRS of inconsistent treatment allows the IRS to assess any tax under its math error authority. However, if the partner does notify the IRS of inconsistent treatment, the IRS is required to audit the partnership to assess tax against the partner, which is different from TEFRA where the IRS could issue a notice of deficiency against the partner without a partnership audit.

Treasury would be given authority to promulgate necessary and appropriate regulations to implement the proposal to: include rules about the designation of a person to act on behalf of the partnership; ensure that taxpayers do not transfer partnership interests with a principal purpose of utilizing the SPP regime to alter taxpayer's tax liability; address foreign passthrough partners issues; and provide rules for passthrough partners to challenge an assessment.

KPMG observation

This proposal has many unanswered questions concerning its implementation and consequences especially with respect to passthrough partners. For example, if a passthrough partner is a 10% partner, does the IRS simply assess tax on 10% of the adjustment at the highest rate of tax without regard to whether any of the indirect partners are: (1) tax-exempt entities; (2) would not have any additional tax liability if the adjustments were passed through, etc. This would result in a tremendous burden and cost on each partnership in a multi-tiered partnership arrangement to challenge the adjustment and have its partners file amended returns or prove that the tax has been paid. The change in the SPP that does not allow a partner to participate in the audit is also troubling as a partner's rights to challenge the merits of the adjustment have been abrogated and the failure of the authorized person to present a robust defense may cause the partner to have a deficiency on a partnership item that the partner cannot challenge. The partner may challenge the calculation of the deficiency but not the merits of the adjustment. This proposal incorporates some of the principles discussed in the Camp tax reform bill.

The proposal would apply to a partnership's tax year ending on or after the date that is two years from the date of enactment.

The 2015 proposal also would have eliminated TEFRA but retained ELP and created a new regime that was much different from the SPP proposal.

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