KPMG

Analysis and observations of tax proposals in Biden Administration’s FY 2025 budget

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Introduction

This report represents KPMG's analysis of the Biden Administration's tax proposals provided in the General Explanations of the Administration's Fiscal Year 2025 Revenue Proposals [PDF 2 MB], prepared by the Department of the Treasury (Treasury), released on March 11, 2024. This Treasury document, better known as the Green Book, outlines the Biden Administration's proposals for reforming and improving the U.S. tax system.

Most of the proposals in this year's Green Book are familiar ones, having been proposed in prior years. There are some notable changes however, including a proposed increase in the corporate alternative minimum tax (CAMT) rate from 15% to 21%. But the greater importance for this year's Green Book is not what it means for 2024, but what it potentially tells us about 2025. These proposals will likely serve as the basis of the Biden Campaign tax plan, giving us insight into the coming tax agenda should President Biden win reelection. With trillions of dollars' worth of tax provisions expiring at the end of 2025, tax will undoubtedly be on the White House agenda next year, no matter who prevails this November. With tax-writers of both parties potentially in pursuit of good tax ideas, many of the proposals discussed below could be in consideration.

Background

The Biden Administration transmitted its FY 2025 budget recommendations to Congress on March 11, 2024. [Read ***TaxNewsFlash***.] In its FY 2025 budget, the administration laid out its annual spending plan for the fiscal year beginning October 1, 2024, for discretionary and mandatory programs and interest on the debt. The projected cost of the proposed expenditures is $7.3 trillion.

As noted above, the budget recommendations include the administration's tax plan, not only the upcoming fiscal year, but also for the political campaign and as a marker for the beginning of consideration of revenues for 2025 and beyond. The expiration of many of the TCJA tax cuts in 2025 and growing concerns over deficits gives considerable post-election salience to revenue matters.

The budget transmitted to Congress this week proposes tax increases that total nearly $5.6 trillion over 10 years, as well as tax reductions and benefits totally $988 billion. Net of new spending proposals, the budget would reduce deficits by about $3 trillion over 10 years according to the administration.

Tax proposals

The administration's budget proposals would, in general, increase and reform corporate and international taxation, as well as increase individual taxes on those with annual earnings exceeding $400,000. According to the administration, these proposals are intended to "reduce the deficit by cracking down on fraud, cutting wasteful spending, and making the wealthy and corporations pay their fair share."

Business tax proposals include:

- Increase the corporate rate to 28%
- Increase the CAMT rate to 21%
- Reform international taxation
  - Increase the global intangible low-taxed income (GILTI) rate to 21%
  - Repeal the deduction for foreign-derived intangible income
  - Adopt an under-taxed profits rule
- Quadruple the stock buyback tax
- Deny the deduction for all compensation over $1 million for all C corporations

- Modify depreciation and fuel tax rules for corporate aircraft
- Eliminate tax preferences for fossil fuels
- Eliminate tax-free treatment of like-kind exchanges
- Strengthen the limitation on losses for noncorporate taxpayers
- Modify due dates for certain information returns

Individual tax proposals include:

- Restore the American Rescue Plan Act expanded child tax credit
- Expand the low-income housing tax credit
- Provide a new tax credit for first-time homebuyers
- Increase the top income tax rate
- Increase the Medicare rate and net investment income tax rate
- Apply the net investment income tax to pass-through business income
- Impose a 25% minimum tax on those with wealth exceeding $100 million
- Tax capital gains at ordinary rates for households with over $1 million in earnings
- Tax unrealized gains at death

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

KPMG observation

The prospects for the near-term enactment of major tax proposals such as those proposed by the administration are extremely slim. The combination of 2024 being an election year and the current divided government, suggests that the climate is simply not right for the enactment of major tax legislation. Still, the administration's tax plan is relevant for several reasons.

First, these budget and tax proposals are likely to form the Biden Campaign tax plan as we head into the presidential election season. These proposals may well stand in contrast to Republican tax plans, which may focus primarily on extending the expiring tax cuts of the TCJA.

Secondly, these proposals are likely to become the opening for Democrats in negotiation of revenue and spending legislation in 2025 and beyond. The expiration of the TCJA tax cuts and renewed concern about increasing federal deficits could lead either party to the consideration of revenue proposals post-election.

Thirdly, the administration's international proposals in the budget are intended in large part to conform U.S. tax rules to the OECD's BEPS agreement. As much of the OECD plan is on the verge of implementation internationally, other countries are paying close attention to the actions of the U.S.

Finally, it is worth observing that tax proposals, once released, never truly disappear. These ideas have a long shelf life in the tax policy world and are likely to reappear in various formats in the years (perhaps decades) to come. Projected deficits and the inevitable desire for new spending programs will raise the question of revenue offsets. First among the potential offsets are proposals that might arguably be said to address abuses or "loopholes."

A final observation about effective dates and revenue estimates. The former are needed to provide a basis for the latter. So, Treasury provides effective dates, usually date of enactment or tax years including or beginning after date of enactment. Effective dates are, however, the exclusive province of Congress. Changes and transition rules are to be expected, should any of these proposals be enacted. And revenue estimates made by Treasury may vary significantly from the estimates of the Congressional Joint Committee on Taxation, which are the estimates used by Congress. Differences in assumptions, baselines, and decisions about ordering of provisions with interactive effects can produce significantly different estimates.

Reform business taxation

Raise the corporate income tax rate to 28%

The TCJA replaced the graduated C corporation income tax rates, which had included a maximum rate of 35%, with a flat rate of 21%. The administration's proposal would increase the flat corporate income tax rate from 21% to 28%.

The provision would be effective for tax years beginning after December 31, 2023. For fiscal year corporations with a tax year that straddles January 1, 2024 (i.e., a tax year beginning in 2023 and ending in 2024), the proposal would apply a tax rate equal to (1) 21% plus (2) 7% multiplied by the portion of the tax year that occurs in 2024.

KPMG observation

The administration states that this proposal, estimated by Treasury to raise more than $1.3 trillion over 10 years, is an administratively simple way to raise revenue to pay for the administration's fiscal priorities, increase progressivity, and help reduce income inequality. Implicitly recognizing studies regarding foreign ownership of U.S. stock, Treasury argues that a significant share of the revenue estimated to be raised by the proposal would be indirectly borne by foreign investors.

If enacted, the proposal would reverse half of the 14-percentage point reduction in the maximum corporate income tax rate enacted in the TCJA. This would represent a significant increase in the corporate income tax rate.

The proposal would "blend" the current and proposed tax rates for fiscal years that begin in 2023 and end in 2024. In general, absent a specific override, existing section 15 also provides for a blended tax rate if the effective date of a tax rate change is not the first day of a tax year. Both the proposal and section 15 calculate the blended rate based on the number of days in the tax year before and after the effective date of the change; it is not clear whether the proposal is specifically intended to provide for different results than the results that would arise under section 15.

The TCJA had, in connection with the reduction in the maximum corporate income tax rate, reduced the 80% dividends received deduction (DRD) (for dividends from 20% owned corporations) to 65% and the 70% DRD (for dividends from less than 20% owned corporations) to 50%. The TCJA changes in the DRD rates had maintained a rough parity between the maximum effective corporate tax rate imposed on dividends subject to the DRD before and after the TCJA's change to the corporate tax rate. For example, prior to the TCJA, a $100 dividend received by a corporate taxpayer subject to a 35% tax rate and eligible for the 80% DRD would generally have resulted in ($100 * (1 – 80%)) * 35%, or $7 of tax. Following the TCJA, the same dividend generally results in ($100 * (1 – 65%)) * 21%, or $7.35 of tax. The proposal does not include any similar adjustment to the DRD rates.

The proposal, if enacted, would represent the second major change to the corporate income tax rate in eight years. These rate changes can increase the importance of the timing of income and deductions and can affect the value of tax attributes, such as carryovers of net operating losses (NOLs), capital losses, and deferred interest deductions under section 163(j). For example, a corporation’s deduction in a 2020 tax year could have potentially offset income that was or would be taxed (1) at 21% if the deduction was absorbed in the 2020 tax year, (2) at 35% in a pre-TCJA year if the deduction created or increased a NOL in 2020 and the NOL was carried back under the expanded loss carryback provisions enacted by the “Coronavirus Aid, Relief, and Economic Security Act” (CARES Act), or (3) at 28%, if the proposal is enacted and the deduction created or increased an NOL in 2020 and the NOL is carried forward to a year in which the proposal is effective.

Increase the corporate alternative minimum tax rate to 21%

The corporate alternative minimum tax (CAMT) was signed into law on August 16, 2022, as part of Pub. L. No. 117-169—the legislation commonly referred to as the “Inflation Reduction Act” (IRA). The CAMT is effective for tax years beginning after December 31, 2022. At a very high level, the CAMT generally imposes a 15% minimum tax on the adjusted financial statement income (AFSI) of large corporations whose three-year average annual AFSI exceeds $1 billion (“applicable corporations”).

The administration’s proposal would increase the CAMT rate from 15% to 21% for tax years beginning after December 31, 2023. This proposal is estimated to raise approximately $137.4 billion over the 10-year budget window (i.e., between 2025 and 2034).

KPMG observation

This is the first administration budget to propose a change to the CAMT.

The administration’s proposal to increase the CAMT rate by 6% (from 15% to 21%) should be viewed alongside the administration’s proposals, discussed above and below, to increase the “regular” tax rate on C corporations by 7% (from 21% to 28%) and to increase the global intangible low-taxed income (GILTI) rate. It is worth noting that the differential between the regular tax rate and CAMT tax rate would increase (by 1%) if both proposals were enacted, and the 21%-rate would be the same as the proposed effective GILTI rate of 21%.

Increase the excise tax rate on repurchase of corporate stock and close loopholes

The IRA imposed a non-deductible excise tax (the “stock repurchase excise tax”) on repurchases of stock of certain publicly traded corporations. In general, the stock repurchase excise tax applies to repurchases of stock by a publicly traded domestic corporation (a “covered corporation”) that occur after December 31, 2022. This tax generally applies at a rate of 1% of the fair market value (FMV) of any stock of a covered corporation that is repurchased by the corporation during its tax year. The statute defines a repurchase to include any redemption within the meaning of section 317(b) and any other transaction determined by the Secretary to be economically similar to a redemption. The statute also treats certain acquisitions of stock of a covered corporation by affiliates of that covered corporation (“specified affiliates”) as repurchases. The annual FMV of a covered corporation’s repurchased stock is reduced by certain exceptions and reductions, generally including the FMV of the covered corporation’s stock that is issued during the tax year. The statute also applies the stock repurchase excise tax to certain acquisitions of the stock of a publicly traded foreign corporation by U.S. specified affiliates of that foreign corporation.

The proposal would increase the rate of tax imposed on stock repurchases to 4% (from 1%). The proposal would also impose the stock repurchase excise tax on purchases of the stock of an applicable foreign corporation by specified affiliates that are controlled foreign corporations (CFCs).

The proposed rate increase would apply to repurchases of stock after December 31, 2023.

The Green Book estimates that the proposal would raise almost $4 billion in 2024 and approximately $166 billion between 2025 and 2034.

KPMG observation

Stock repurchases or "buybacks" are reported to have reached a record $1.2 trillion in 2022, with similarly high volumes of buybacks reported in 2023. This suggests that the 1% stock repurchase excise tax has not significantly influenced corporate decision-making with respect to stock buybacks. The proposal, by increasing the cost of a stock buyback, may cause at least some corporations to reevaluate their buyback plans, but would raise additional revenue from corporations that choose to implement stock buybacks.

As stated above, the statute currently imposes the stock repurchase excise tax on a U.S. specified affiliate of a foreign, publicly-traded corporation to the extent that U.S. affiliate acquires its foreign parent's stock from an unrelated seller. The proposal would expand this rule to include stock purchases by a specified affiliate that is a CFC. While presumably the proposal is intended to apply to CFCs directly or indirectly owned by a U.S. corporation, it is not clear whether it would extend to CFCs that are "technical" CFCs following the repeal of section 958(b)(4). For example, if a publicly-traded foreign parent owns a U.S. corporation and a foreign corporation (FSub), FSub generally will constitute a CFC as a result of the stock attribution rules. Thus, repurchases of stock of the foreign parent by FSub, a CFC, seemingly could be caught by the proposal, although this is not clear from the limited description provided.

The Green Book does not reference Notice 2023-2, in which Treasury announced a potentially significant expansion of the scope of the statutory rule for publicly traded foreign corporations. Notice 2023-2 indicates that regulations will apply the stock buyback excise tax when the U.S. subsidiary "funds by any means" its foreign parent's repurchase of stock and the funding was undertaken with a principal purpose of avoiding the tax. Moreover, Treasury included in the notice an irrebuttable presumption that a funding (other than a distribution) was undertaken with a tax avoidance purpose if the foreign parent repurchased its stock within two years of the funding. The scope of this "funding rule" is uncertain, because the phrase "funds by any means" is inherently vague and because there are no exceptions for ordinary course transactions or for unrelated short-term financing (such as occurs in everyday cash pooling activities). This uncertainty is exacerbated by the *per se* presumption that a funding was undertaken with a tax avoidance motivation. The significance of this *per se* rule would increase if it were to be retained in temporary or final regulations and if the tax rate increases to 4%. Moreover, if the above proposal does extend to "technical" CFCs, and theses CFCs are subject to the same "funding rule" for U.S. subsidiaries described in Notice 2023-2, the stock buyback excise tax would have an incredibly broad and complex application to foreign-parented multinationals. In public statements, Treasury personnel have indicated that forthcoming regulations may have a more limited reach than suggested by Notice 2023-2.

Tax corporate distributions as dividends

The administration seeks to expand the scope of corporate distributions that are treated as dividends. In the Green Book it asserts that corporations have devised ways to avoid dividend characterization of certain distributions of property, such as through certain transactions that reduce a corporation's earnings and profits (E&P) but do not result in a reduction in a corporation's dividend paying capacity. The administration views these transactions as inconsistent with a corporate tax regime in which E&P is viewed as measuring a corporation's dividend-paying capacity.

Prevent elimination of E&P through distributions of certain stock with basis attributable to dividend equivalent redemptions

The proposal would amend section 312(a)(3) to provide that the reduction to E&P of a corporation on its distribution of certain "high-basis stock" would be 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.

KPMG observation

In general, a corporate distribution is treated as a dividend to the extent made out of E&P for the year of distribution (computed as of the close of the year without diminution by reason of any distributions made during the year), or from E&P accumulated in prior years. To the extent a distribution exceeds the amount of available E&P, the distribution generally is applied against (and reduces) the shareholder's basis in the corporation's stock, and to the extent in excess of such basis is treated as gain from the sale or exchange of property. The amount of a distribution is based on the amount of money plus the fair market value of other property received.

Subsequent to the repeal of the *General Utilities* doctrine in 1986, corporations generally recognize gain on the distribution of appreciated property; losses on the distribution of loss property are not allowed. However, when the distributing corporation distributes loss property, its E&P generally is reduced (but not below zero) under section 312(a)(3) by its adjusted basis in the distributed loss property.

For example, assume a corporation with significant amount of current and accumulated E&P distributes property with a value of $70, in which it has an adjusted basis of $100. The corporation's $30 loss on the distribution is disallowed. The corporation's E&P (but not its current E&P) generally is reduced by its $100 basis in the distributed property (the corporation generally does not reduce its E&P by the amount of the disallowed loss, because such a reduction would be duplicative).

When a corporation redeems (or constructively redeems) its stock in exchange for money or other property, the shareholder generally is treated under section 302 either (1) as engaging in a sale or exchange of the stock, or (2) as receiving a distribution of property to which section 301 applies (*i.e.* a "dividend equivalent" redemption). When a shareholder receives a distribution of property from a corporation in a dividend equivalent redemption, the distribution is treated as a dividend to the extent of available E&P. As with other distributions, to the extent such a redemption distribution exceeds the amount of available E&P, the distribution generally is applied against (and reduces) the shareholder's basis in the corporation's stock, and then is treated as gain from the sale or exchange of property. If the redeemed shareholder's basis in the redeemed stock is not fully recovered under section 301(c)(2) (either because the distribution was out of E&P or due to basis that exceeds the section 301(c)(2) amount), the shareholder's basis in any non-redeemed stock it owns in the corporation is increased by the shareholder's unrecovered basis in the redeemed stock. If the shareholder no longer directly owns shares in the redeeming corporation (*e.g.*, when the redemption is treated as dividend equivalent solely as a result of constructive stock ownership), the shareholder's unrecovered basis in the redeemed shares can "jump" to other shares in the same corporation held by a related party. *See, e.g.,* Treas. Reg. § 1.302-2(c), Example 2.

Corporate taxpayers can use the rules described above to shift basis in certain shares to other shares (including through redemptions and section 304 transactions), and thereby create a loss in such other shares. The proposal would modify the E&P rules under section 312(a)(3) to provide that the distributing corporation’s E&P reduction would be determined without regard to basis adjustments resulting from actual or deemed dividend equivalent redemptions.

The proposal appears limited to the E&P consequences of these transactions; it does not appear to affect or reduce the tax basis in the distributed “high-basis” shares. Such a basis adjustment might not be necessary, given that under current law the distributing corporation’s loss in the distributed shares generally would be disallowed and the shareholder’s basis in the distributed shares would be equal to the fair market value of such shares as of the distribution date.

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

The Green Book 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 would be effective for transactions occurring after December 31, 2024.

KPMG observation

As noted above, a corporate distribution is treated as a dividend to the extent it is out of current or accumulated E&P. However, a corporation that has no E&P can borrow funds with which to make a distribution, with the distribution resulting in a tax-free basis recovery to the recipient shareholder. The IRS has periodically sought to challenge these so-called leveraged distributions. Initially, the IRS argued that such distributions were anticipatory distributions of future profits and thus should be taxed as dividends; courts largely rejected these arguments, even in situations when the distributing corporation’s borrowings were guaranteed by federal agencies. *See Gross v. Commissioner*, 236 F.2d 612 (2d Cir. 1956) (statutorily overruled in present section 312(i) in the context of federally insured loans) and *Commissioner v. Godley’s Estate*, 213 F.2d 529 (3d Cir. 1954). The IRS lost a similar case in *Falkoff v. Commissioner*, 604 F.2d 1045 (7th Cir. 1979), when a parent corporation borrowed funds from a bank in the last days of a tax year to fund a return of basis distribution, followed days later (in the succeeding tax year) by a sale of real estate by its subsidiary corporation and use of those proceeds to repay the bank loan. The court noted that the taxpayer’s intentional use of the timing aspects of the tax system to distribute funds in a year prior to the creation of E&P simply delayed rather than denied tax, due to the corresponding reduction in stock basis under section 302(c)(2).

More recently, in *Illinois Tool Works v. Commissioner*, T.C. Memo. 2018-121, the IRS unsuccessfully challenged a taxpayer’s leveraged distribution. There, a US corporation owned a first-tier CFC, which owned all of the stock of a second-tier CFC. The first-tier CFC was a holding company and held no other substantial assets and had no E&P. The second-tier CFC had significant direct and indirect business operations and a large amount of E&P. The second-tier CFC loaned funds to the first-tier CFC, which were then distributed in a section 301 return of basis distribution to its US shareholder. The court held the loan to the first-tier CFC to be a *bona fide* debt. In addition, the court declined to adopt the IRS request to deploy one or more judicial anti-avoidance doctrines (such as a step transaction, economic substance doctrine, or conduit theory), to combat what it perceived as avoidance of the purposes of subpart F. The court found that because the advance from the second-tier CFC to the first-tier CFC was a *bona fide* loan, and because the second-tier CFC could not directly pay a dividend to the US shareholder (who did not directly own any stock in the second-tier CFC), the first-tier CFC did not act as a conduit.

It is not clear the extent to which the proposal is aimed at transactions similar to those at issue in the *Falkoff* and *Illinois Tool Works* cases, when distributions are made by an E&P-free corporation with funds directly or indirectly sourced from a related corporation. The proposal would treat what is otherwise a return of basis distribution from one corporation as the receipt of a dividend directly from a related corporation to the extent the related corporation funds the distributing corporation with a principal purpose of not treating the distribution as a dividend from the funding corporation. It appears that this proposal would capture a distribution by a brother corporation of funds borrowed from a sister corporation. However, both *Falkoff* and *Illinois Tool Works* involved distributions arguably "funded" within a corporate chain, and it is not clear the proposal would literally apply in many such cases. For example, if a parent corporation borrowed funds to make a distribution, with the borrowing supported by the assets of a subsidiary corporation (and to be repaid by a distribution from the subsidiary in a subsequent tax year), seemingly there could be no "purpose" of avoiding a dividend from the subsidiary to the shareholders of parent given that parent, not parent's shareholders, own the stock of subsidiary. The Tax Court in *Illinois Tool Works* cited this notion in rejecting the IRS's conduit argument. However, this might reflect the manner in which the proposal is articulated rather than its intent. The Green Book's statement of purposes underlying the proposal would seem to reach this sort of leveraged distribution, and this issue could be addressed in legislative language implementing the proposal.

The proposal does not specify how it would determine whether "a principal purpose" exists. In other potentially analogous contexts, "per se" funding rules have been promulgated to deem a principal purpose to exist when a "funding" occurs sufficiently close in time to the transaction at issue. For instance, per se funding rules are included in the section 385 regulations, which are intended to recharacterize certain related party indebtedness as equity, and in Notice 2023-2, which relates to the stock repurchase excise tax (discussed above). The potential reach of those *per se* rules is extraordinarily broad, pulling in transactions with a general temporal relationship to a distribution or stock repurchase, regardless of whether there might be any factual or causal connection. These *per se* rules are controversial, and they have yet to be tested in a reported court decision.

If a *per se* rule were imposed as part of (or in connection with) this proposal, we would anticipate the need for exemptions for ordinary course transactions (such as intercompany sales of inventory for resale) and unrelated short-term funding arrangements (such as routine intercompany payables and cash pooling arrangements). We would also anticipate the need for a series of rules to address the collateral consequences of the fiction of a dividend distribution from the funding corporation. For example, assume that in Year 1, a parent corporation borrowed funds from an unrelated lender and distributed the proceeds to its shareholders in a leveraged distribution, and that in Year 2 a non-consolidated subsidiary corporation distributed cash to the parent corporation (out of the subsidiary's E&P), which the parent corporation used to repay the borrowing. If this were to be treated as though the subsidiary corporation had paid a dividend directly to the shareholders of the parent corporation, what adjustments might be necessary? What if the parent corporation owned less than all of the stock in the subsidiary? Could this allow for subsequent distributions by the subsidiary to its minority owners to be return of basis distributions (rather than dividends)? Would there be a need to adjust the parent corporation's shareholders' bases in the stock of the parent, or the parent's basis in the stock of the subsidiary (or of any intervening entities if the subsidiary is lower-tier), if the distribution were considered an extraordinary dividend under the rules of section 1059? If the proposal were to apply to distributions from CFCs, would there be a need to provide coordinating rules with the rules in subpart F (including the rules relating to distributions of PTEP and basis adjustments under section 961)? The one thing that seems relatively clear is that this proposal can reasonably be expected to add significant additional complexity.

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 issued by a direct or indirect corporate shareholder ("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 proposal would disregard a subsidiary's purchase of hook stock for property. Instead, the money or other property used to purchase the hook stock would be treated as 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 (*i.e.*, partnerships) 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, 2024.

KPMG observation

There has been longstanding concern that certain issuances of stock to other corporations in nonrecognition transaction may result in the corporate transferee taking a tax basis of $0 in the acquired stock under general transferred basis provisions. Currently, in many cases Treas. Reg. §§ 1.1032-2 and 1.1032-3 apply to prevent the transferee corporation from taking a "zero basis" and, therefore, from having gain equal to the full value of the stock or "zero basis gain" on a disposition. However, the purchases of hook stock addressed by this proposal may not be eligible for relief from a zero basis issue under existing rules. Therefore, the proposal not only creates a potentially taxable dividend but also a potential tax basis of $0 (and the potential for zero basis gain) in the hook stock received by the subsidiary.

Repeal gain limitation for dividends received in reorganization exchanges

One hundred years ago, Congress enacted the predecessor to section 356(a)(1), which currently provides that if, as part of a reorganization, a shareholder receives stock and "boot" in exchange for its stock in the target corporation, 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). In certain limited situations, the entire amount of boot can be viewed as a separate distribution (and thus as a dividend, to the extent of E&P), in the context of recapitalizations and related-party reorganizations (*see Bazley v. Commissioner*, 331 U.S. 737 (1947) and Treas. Reg. § 1.301-1(j)) and, in the context of an "F reorganization," *see* Treas. Reg. § 1.368-2(m)(3)(iii)).

The 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 proposal would align the available pool of E&P to test dividend treatment with the rules of section 316 governing ordinary distributions.

The proposal would be effective for transactions occurring after December 31, 2024.

KPMG observation

The proposal refers to the rules under section 316 for purposes of determining the available pool of E&P, while an earlier Obama Administration proposal referred to “all of the available earnings and profits of the corporation.” It appears that this change may have been intended to clarify that the deemed dividend should follow normal dividend rules and not provide an E&P priority to boot dividends.

Limit tax avoidance through inappropriate leveraging of parties to divisive reorganizations

Background

A divisive reorganization under sections 368(a)(1)(D) and 355 (a “Divisive Reorganization”), commonly referred to as a spin-off, a split-off, or a split-up, 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 and/or transfers money (e.g., the proceeds of borrowing or an initial public stock offering) to D as partial consideration in the exchange, which, subject to basis limitations, generally can be received and distributed tax-free by D to its shareholders and creditors under current law. As part of the Divisive Reorganization, C may also assume D’s liabilities as part of the exchange.

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) generally extends nonrecognition treatment to D’s 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) 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 extract value from the assets contributed to C in a tax-free manner in connection with a Divisive Reorganization. However, Treasury identifies what it describes as two “safe harbors” that allow some extraction of value to occur in Divisive Reorganizations without D recognizing gain. First, D generally does not recognize gain if the aggregate of (1) the liabilities assumed by C and (2) the boot (including C non-securities debt) transferred by C to D and then distributed by D to its creditors does not exceed the aggregated adjusted tax basis of the property D transfers to C (the “Adjusted Basis Limitation”). Second, 361(c)(3) permits the tax-free transfer of C’s stock and debt received in the exchange to D’s creditors.

In addition, the Green Book notes that certain contingent liabilities that may be assumed by C are not taken into account for purposes of the Adjusted Basis Limitation. The Green Book also states that there are no adequate safeguards to ensure C’s adequate capitalization or continued economic viability following a Divisive Reorganization.

Proposal

The proposal would address both the perceived “monetization” available in Divisive Reorganizations as a result of the two “safe harbors” described above, as well as the perceived potential to “overleverage” C through C’s assumptions of contingent liabilities of D. These proposals generally would be effective for transactions occurring after enactment. However, the new rules would not apply to any distribution pursuant to a Divisive Reorganization described in a ruling request initially submitted to the Internal Revenue Service on or before the date of enactment (if the request has not been withdrawn and for which a ruling has not been issued or denied in its entirety as of such date).

“Eliminate excessive tax-free monetization of divisive reorganizations”

This proposal would modify the two “safe harbors” through the introduction of a new quantity, the “excess monetization amount.” This amount would be equal to (a) the sum of the following four items: (1) the total amount of liabilities assumed by C, (2) the total amount of C boot (excluding C non-securities debt) transferred to D’s creditors, (3) the fair market value of the nonqualified preferred stock transferred to D’s creditors, and (4) the total principal amount of C debt transferred to D’s creditors, reduced by (b) the total adjusted bases of the assets transferred by D to C.

An excess monetization amount could cause D to recognize gain in two ways. First, D would recognize dollar-for-dollar gain equal to the lesser of D’s excess monetization amount or the amount of C boot (defined as money and other property other than C debt in this proposal) that D transfers to its creditors (“First Prong”). Second, D could also recognize gain if D’s excess monetization amount exceeds the amount of C boot that D transfers to its creditors. Specifically, this remaining excess monetization amount would cause an equal principal amount of C debt that is transferred to D’s creditors to be treated as if sold in a taxable sale (“Second Prong”).

To illustrate, if D’s excess monetization amount equaled $5 billion, and D transferred $4 billion of C boot and $1 billion of C debt to D’s creditors, D would recognize gain to the extent that $1 billion exceeds the adjusted basis of the C debt. This would be in addition to the $4 billion in dollar-for-dollar gain on the C boot transferred to D’s creditors.

KPMG observation

The existing statutory rules serve an important business function in Divisive Reorganizations by allowing D the flexibility to reallocate its debt between its continuing business (or businesses) and the continuing business (or businesses) 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. The Service has struggled with this and related issues and has periodically modified the no-rule areas in its private letter rulings practice (and released proposed regulations in 2016 under the section 355 “device” and active business requirements) but has consistently provided letter rulings consistent with current law.

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.

The proposal, which is the same as the one that appeared in the 2024 Green Book, appears similar in intent to statutory language amending section 361 that was included in the legislative text of the Build Back Better Act released by the Senate Finance Committee on December 11, 2021. The House had passed a version of this legislation on November 19, 2021, but the legislation never passed the Senate. The intent both in the prior draft legislation and the current proposal appears to be to limit 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 FY 2025 proposal appears to be based on the questionable premise that all C debt (whether or not a "security") more resembles cash than an equity interest, contrary to U.S. Supreme Court's treatment of indebtedness that constitute "securities" for purposes of the reorganization provisions. Moreover, the proposal presents several ambiguities that presumably will be clarified in proposed legislation. First, the term "C boot" is defined as money and other property other than "C debt," which in turn is defined as securities or other debt obligations of C. The term C boot also excludes the assumption of liabilities by C. Accordingly, it appears that neither the assumption of liabilities by C nor C non-securities debt would be subject to the dollar-for-dollar gain recognition under the First Prong. Second, the Second Prong causes any excess monetization amount in excess of the C boot transferred to D creditors to be treated as a sale by D of a principal amount of C debt equal to the remaining excess monetization amount. The resulting gain under the Second Prong will depend on D's basis in the C debt that is deemed sold. Under section 361(a), C securities debt and C nonqualified preferred stock constitute "qualified property," the receipt of which is tax-free to D and to which D must allocate basis under section 358(a)(1). On the other hand, C non-securities debt may be received tax-free only if the distribution requirements under section 361(b)(1)(A) and (b)(3) are satisfied. The proposal, as well as the prior draft legislation, do not provide for amendments to the basis determination rules under section 358, and it is unclear how such rules would apply to property that is taxed under the First Prong and Second Prong. Even if section 361(b)(1)(A) and (b)(3) are satisfied, D may receive a fair market value basis in the C non-securities debt under section 358(a)(2). As a result, the amount of gain that may be recognized under the Second Prong will depend not only on the proper basis allocation under section 358 but also the stacking or ordering of C securities debt, C non-securities debt, and/or C nonqualified preferred stock that is deemed sold.

"Prevent tax avoidance through the transfer of contingent liabilities to C"

To address the perceived lack of existing safeguards to ensure C's adequate capitalization or continued economic viability following a Divisive Reorganization, the proposal would impose two additional requirements under section 355 that, if not satisfied, would result in gain recognition by D (but not D's shareholders). First, C would be required to be adequately capitalized as a result of the Divisive Reorganization. Second, C must continue to be an economically viable entity after the completion of the Divisive Reorganization. The satisfaction of these requirements would be based on all relevant facts and circumstances including (1) the projected, as well as actual, amount of contingent D liabilities assumed by C, and (2) whether C declares bankruptcy within the five-year period following the Divisive Reorganization. The fact that one or more creditors would be willing to lend to C is stated to be irrelevant to the determination. In addition, the proposal would authorize regulations to carry out the purposes of the proposal or to prevent the avoidance of tax.

KPMG observation

Under current law, a post-distribution cessation in C's business might call into question whether the "active trade or business" requirement of section 355(b) was met. This proposal is aimed at providing further requirements that assess C's viability as a business, particularly with respect to any assumed contingent liabilities. Although the proposal identifies certain facts that would be pertinent in assessing these new requirements, it appears that the administration intends to defer to the Secretary to provide more clear guidance on what scenarios might run afoul of the intended purpose of this proposal or what mechanisms would be applied (e.g., how frequently would C's economic viability be tested or in what year would D recognize gain if C were to fail the economic viability test several years post-distribution). The proposal seems to imply that the current corporate and securities law restrictions are not enough to ensure viable controlled corporations. Query whether corresponding requirements (1) to ensure adequate capitalization of D and (2) to ensure D is an economically viable entity following the Divisive Reorganization may be considered to prevent a perceived inappropriate retention by D of contingent liabilities.

Limit losses recognized in liquidation transactions

A shareholder of a liquidating corporation generally recognizes gain or loss on the receipt of assets from the liquidating corporation in complete liquidation under section 331, and the liquidating corporation recognizes gain or loss (subject to certain loss limitation rules) on its distribution of property to its shareholders under section 336. Under section 332, if a corporation owns stock in a subsidiary corporation that possesses 80% or more of the total vote and value of the subsidiary's outstanding stock, the 80% corporate shareholder does not recognize gain or loss on its receipt of assets from the subsidiary in complete liquidation and, under section 337, the liquidating subsidiary corporation generally does not recognize gain or loss on property distributed to the 80% corporate shareholder. (Different rules can apply with respect to liquidations of insolvent corporations.)

Section 267(f)(2) generally provides that losses recognized on sales or exchanges of property between members of a controlled group of corporations generally are deferred until the property is transferred outside the controlled group. A controlled group is defined by reference to the section 1563(a) definition and using a more than 50% of vote or value stock ownership threshold.

The proposal would modify section 267 to deny the recognition of losses with respect to the stock or securities of a liquidating corporation and the property it distributes in a complete liquidation to which sections 331 and 336 apply if the assets of the liquidating corporation remain in the controlled group after the liquidation. Treasury would be granted regulatory authority to issue guidance to allow for the deferral, rather than the denial, of such losses under the principles of section 267(f), as well to address the use of controlled partnerships to avoid these rules.

This proposal would apply to distributions occurring after the date of enactment.

The proposal is estimated to increase revenues by approximately $547 million over 10 years.

KPMG observation

Unlike similar proposals that had been included in versions of the proposed build back better act, the proposal would apply not only to disallow losses in the stock of the liquidating corporation, but also to disallow the liquidating corporation's loss on the liquidating distribution of its assets. However, unlike certain prior proposals, the Green Book proposal does not appear to apply to dissolutions of insolvent subsidiaries, which may result in worthless stock deductions for the shareholder under section 165(g) and loss for the dissolving corporation on the deemed sale of its assets.

The proposal indicates that the change is intended to address "*Granite Trust*" planning as well as loss recognition on property held by the liquidating corporation. At a high level, a *Granite Trust* transaction generally involves a transaction in which a parent corporation attempts to recognize a loss on the stock of a subsidiary (and avoid the application of the tax-free subsidiary liquidation rules of section 332) by reducing its stock ownership in a controlled subsidiary below the relevant 80% stock ownership requirement, thereby positioning it to recognize a stock loss under section 331 upon the subsidiary's complete liquidation. This transaction can also result in the recognition of losses on property held by the liquidating corporation under section 336. 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 (if necessary, to any person outside of the tax-consolidated group of which the parent corporation is a member, due to the consolidated stock ownership aggregation rule in Treas. Reg. § 1.1502-34). Such a transaction often takes the form of a sale of, say, 30% of the subsidiary's stock to a related partnership or foreign corporation. Under current law, 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 if the transfer is not a dividend-equivalent exchange under section 304(a) in which basis in the transferred minority interest is credited to the parent's remaining 70% interest in the liquidating subsidiary. However, section 267(f) does not apply to the parent's loss on its remaining 70% stock interest in the liquidating corporation and the liquidating corporation's losses on property distributed in liquidation. The proposed change would effectively 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 and by the liquidating (distributing) corporation with respect to property distributed to the parent corporation in the liquidation. If enacted, the proposed modification can be anticipated to significantly reduce the volume of *Granite Trust* type tax planning, which has been around for some time (the *Granite Trust* case was decided in 1943).

The proposal would create a default rule that would deny (rather than defer) both the shareholder's stock loss as well as the liquidating corporation's asset-level loss, thus disallowing any deduction with respect to an economic loss. However, in apparent recognition of the unfairness of such a rule, the proposal would explicitly grant Treasury regulatory authority to provide for deferral, rather than denial, of the losses under the principles of section 267(f). If the proposal is enacted, it is unclear whether there would be a gap period (until deferral regulations are issued) in which economic losses would be denied.

While the proposal would deny stock and asset losses within the controlled group, it would not appear to affect the timing of a stock or asset loss recognized by or with regard to an otherwise unrelated minority shareholder in the liquidating corporation.

Prevent basis shifting by related parties through partnerships

If a partnership distributes property to a partner and the partnership has a section 754 election in effect, the partnership may, under certain circumstances, increase or "step-up" the basis of its non-distributed property. This can occur when the distributee partner's basis in its partnership interest is less than the partnership basis in the distributed property. In that case, the distributee partner would "step down" the basis in the distributed property to its basis in its partnership interest and the partnership would step-up basis its remaining property equal to the distributee partner's step down.

Treasury contends that this result may achieve an immediate tax benefit without any meaningful change in economics in certain circumstances. Specifically, for partnerships with related-person partners, a partnership basis step-up could be "designed" to shift basis from non-depreciable, non-amortizable partnership property to depreciable or amortizable partnership property. This could result in immediate increases in depreciation or amortization deductions for remaining partners related to the distributee-partner and achieve an immediate tax savings for the partners as a group without any meaningful change in their economic arrangement. To avoid that result, the administration's proposal would apply a matching rule that would prohibit any partner that is related to a distributee partner from benefitting from a partnership's step-up in basis until the distributee partner disposes of the distributed property in a fully taxable transaction. The proposal would provide the Secretary with authority to prescribe regulations necessary to implement the matching rule.

The proposal would be effective for partnership tax years beginning after December 31, 2024.

KPMG observation

The proposal raises a number of fundamental questions regarding its application. For example, it is unclear how the matching rule would apply following a fully taxable transaction. It is even less clear if and how the matching rule would apply following a non-taxable or partially taxable disposition of the distributed partnership property. Furthermore, the proposal only appears to cover situations when there is a basis shift under section 734 (and not, for example, under section 743 or section 732).

When proposed in 2023, the administration's basis shifting was estimated to raise more than $64 billion over a 10-year period (2024–2033). The current budget attaches a $14.865 billion score to the proposal over a 10-year period (2025–2034). Given the language of the proposals are identical (except for a one-year delay in the effective date), it is unclear why the score changed by approximately $50 billion. While there is a possibility that the score was revised as a result of different baseline assumptions, it is also possible that Treasury considered a wider range of likely taxpayer responses to the proposal and certain administrative complexities attendant to the it.

Conform definition of "control" with corporate affiliation test

The proposal would amend the "control test" under section 368(c) to adopt the "affiliation test" under section 1504(a)(2). Therefore, "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 purposes of defining control as that term is used in connection with tax-free transfers of assets to controlled corporations in exchange for stock (section 351 exchanges), tax-free distributions of controlled corporations (such as in spin-offs), and tax-free corporate reorganizations, control is defined in section 368(c) 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, control for purposes of the affiliation test under section 1504(a)(2) (which is relevant to determining which corporations can join in the filing of a consolidated returns) is defined by reference to the direct or indirect ownership by a parent corporation of stock in another corporation that possesses at least 80% of the total voting power and at least 80% of the total value of the other 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 section 368(c) control test in order to cause a transaction to qualify or not qualify, as desired, for tax-free treatment. For example, a taxpayer may structure a transaction in this manner to avoid tax-free treatment in order to recognize a loss. In addition, the absence of a value component under this standard 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.

This proposal would be effective for transactions occurring after December 31, 2024.

KPMG observation

This proposal is consistent with previous changes made to the affiliation test. For example, 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(c). 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. Similar proposals to conform section 368(c) with section 1504(a)(2) have been made through the years, including by the Clinton and Obama Administrations, but those proposals did not advance in the legislative process.

Strengthen limitation on losses for 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 a taxpayer. The excess business loss limitation is 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 suspended excess business loss 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, and losses will no longer be limited after December 31, 2028. The proposal would remove the provision's present sunset date and make the excess business loss limitation permanent. Significantly, the proposal would also change the manner in which the excess business loss is carried over to a subsequent year. Under the proposal, instead of the excess business loss becoming an NOL in the taxpayer's following year, the excess business loss would become a deduction attributable to a trade or business loss that would be subject to the section 461(l) limitation in the taxpayer's subsequent tax year.

This proposal would apply for tax years beginning after December 31, 2024.

KPMG observation

The proposal, which has been recommended by the administration on prior occasions, 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 then 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. Consecutive years of excess business losses would significantly compound the delay in utilization of such losses.

KPMG observation

This proposal could result in the permanent elimination of the taxpayer's excess business losses. For example, if a taxpayer had a small business that generated significant losses and did not have any other sources of income before the business ceases, the taxpayer could have an excess business loss carryover. If the taxpayer then proceeded to earn only non-business income (including wage income as an employee), such cumulative excess business losses – in excess of the amount afforded to the taxpayer through the annual threshold construct – could be functionally lost to the taxpayer under this proposal. Furthermore, should the taxpayer die without using his or her cumulative excess business losses, then it would appear that the taxpayer's remaining excess business losses could be permanently lost. The proposal would create an excess business loss limitation regime that 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.

Expand limitation on deductibility of employee remuneration in excess of $1 million

Under section 162(m)(1), a deduction limit of $1 million generally applies to compensation paid to covered employees (the principal executive officer, principal financial officer, and the three most highly compensated executive officers for the tax year). The "American Rescue Plan Act" (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 administration's proposal would expand the deduction disallowance under section 162(m) to apply to all C corporations, including both public and privately held corporations, and to all compensation paid by the corporation in excess of $1 million to any employee.

The administration's proposal 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 administration's proposal would amend section 162(m) to provide that otherwise deductible compensation paid to an employee is considered "applicable employee remuneration," subject to the deduction disallowance, whether or not paid directly by the corporation. Further, the administration's proposal would expand regulatory guidance to prevent avoidance of the proposed changes, including through the performance of services other than as an employee or by payment of compensation through a passthrough entity.

The proposal would be effective for tax years beginning after December 31, 2024.

KPMG observation

This would be a significant change to the corporate compensation deduction. Recent changes and proposals have increased the application of 162(m), but the rules have always applied to publicly held corporations and a limited group of employees. This broad proposal would apply to corporations of all sizes and all employees.

Prevent prison facility rent payments from contributing to qualification as a REIT

This proposal would revise sections 856(d)(2) and (d)(3) to treat as nonqualifying income any amount (including rental income) received or accrued, directly or indirectly, with respect to any property a substantial use of which is in connection with punishment, detention, or correction.

The proposal would be effective for tax years beginning after December 31, 2024.

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. Moreover, a similar, somewhat less restrictive measure has been included in some prior legislative proposals, but not enacted. Two U.S. listed companies have operated as REITs while focusing on the operation of prisons. Both companies revoked their respective REIT elections effective for 2021.

KPMG

Reform international taxation

Glossary

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

General introduction to proposals to reform international taxation

Most of the international tax proposals are substantially the same as the those previously included in the FY 2024 Green Book. However, the FY 2025 Green Book does include several additions, essentially reintroducing some proposals from the 2021 House-approved Build Back Better Act, and eliminates certain proposals included in the FY 2024 Green Book.

Eliminated proposals

The FY 2024 Green Book proposals included a requirement that, for all purposes, CFCs compute E&P by taking into account LIFO, installment sales, and the completed contract method of accounting. This proposal, which would have conformed E&P determinations for CFCs more closely with E&P determinations for domestic corporations, has been omitted from the FY 2025 Green Book.

Revise the global minimum tax regime, limit inversions, and make related reforms

Revise global minimum tax regime with respect to controlled foreign corporation earnings

The Green Book contains substantively identical proposals implementing the Pillar Two global minimum tax system that were previously included in prior Biden Administration Green Books.[1] The Green Book also includes additional proposals that are similar to the provisions of the Build Back Better Act (BBBA) that passed the House of Representatives in November 2021.

Substantively identical proposals from the prior Biden Administration Green Books:

- Increasing the GILTI rate from 10.5% to 21% (by a combination of decreasing the section 250 deduction from 50% to 25% and increasing the corporate tax rate to 28%)
- Eliminating QBAI
- Determining GILTI income and limiting foreign tax credits on a jurisdiction-by-jurisdiction basis (with a parallel system for foreign branches)
- Allowance of credit for foreign taxes paid under a foreign income inclusion rule
- Repeal of the high-tax exception for both subpart F and GILTI

In light of several jurisdictions that have recently enacted legislation implementing parts of Pillar Two, including, in several instances, a QDMTT, the Green Book explicitly clarifies that QDMTT's paid under the Pillar Two regime may be creditable against GILTI liability to the extent such tax satisfies the requirements in section 901 or section 903.

Read a May 31, 2021 KPMG report on the FY 2022 Green Book proposals: **KPMG report: Analysis and observations of tax proposals in Biden Administration's FY 2022 budget** [PDF 1.4 MB] (116 pages).

Additional proposals that are similar to the House-passed BBBA:

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[1] A proposal that was previously included in the prior Biden Administration Green Books means a proposal that was included in one or more of the FY 2022, FY 2023, or FY 2024 Green Books (hereinafter referred to as a "reintroduced proposal").

- Unlimited tested loss carryforward for countries with net tested loss
- Reduce foreign tax credit haircut on GILTI taxes from 20% to 5%
- Allow foreign tax credit carryforward for GILTI category (10-year carryforward)

Read a **KPMG report** [PDF 2.4 MB] (210 pages) dated November 19, 2021 that provides analysis and observations about the similar proposal in the House-approved BBBA. The Green Book differs from the House-approved BBBA in two ways. First, the Green Book does not repeal the carryback of foreign tax credits. Second, the Green Book would allow a 10-year carryforward with respect to the GILTI category, whereas the House-approved BBBA would have allowed only a five-year carryforward until December 31, 2030, and a 10-year carryforward thereafter.

The Green Book's proposal to reduce the section 250 deduction would be effective for tax years beginning after December 31, 2023. All other proposals to the existing international tax system would be effective for tax years beginning after December 31, 2024.

Limit the deduction for dividends received from non-controlled foreign corporations

The Green Book contains a proposal similar to the House-approved BBBA proposal limiting the availability of the dividend received deduction under section 245A to dividends received from controlled foreign corporations (CFCs); however, the Green Book proposal would continue to allow a partial DRD for non-CFC dividends impacted by the proposal. [Read a **KPMG report** [PDF 2.4 MB] (210 pages) dated November 19, 2021 that provides analysis and observations about the similar proposal in the House-approved BBBA.] Under current law, section 245A provides a deduction for the foreign-source portion of a dividend received by a U.S. shareholder from a specified 10%-owned foreign corporation (a "section 245A DRD"), subject to the U.S. shareholder satisfying the holding period requirements of section 246(c). The Green Book proposal limits the availability of section 245A DRD to dividends distributed by CFCs or by certain other qualified foreign corporations. Other than CFCs, the term qualified foreign corporation is intended to include corporations that are incorporated in a U.S. territory and those corporations that are eligible to claim the benefits of a comprehensive income tax treaty with the United States. The Green Book proposal would provide that a U.S. shareholder that owns at least 20% of the stock (vote and value) of a qualified foreign corporation that is not a CFC may claim a 65% (reduced from 100%) section 245A DRD. If the 20% ownership threshold is not met with respect to the qualified foreign corporation that is not a CFC, the U.S. shareholder would only be entitled to a 50% section 245A DRD.

The Green Book's proposal would be effective for distributions made after the date of enactment.

Reform the treatment of deductions properly allocable to exempt income

The Green Book's proposal to expand the application of section 265 to disallow deductions allocable to a class of foreign gross income that is exempt from tax or taxed at a preferential rate through a deduction (e.g., a global minimum tax inclusion with respect to which a section 250 deduction is allowed or dividends eligible for a section 245A deduction) and repeal section 904(b)(4) is substantively a reintroduced proposal. Generally, a U.S. shareholder's deductible expenses are allocated in part to the separate GILTI basket and in part to the section 245A subgroup. GILTI inclusions (and the related portion of CFC stock) are characterized, in part, as exempt income under section 864(e)(3) ("exempt asset rule") by reason of the section 250 deduction. As a result, no expenses are allocable to that portion of the GILTI inclusion, or CFC stock generating the GILTI inclusion. Additionally, pursuant to section 904(b)(4), expenses allocable to a dividend eligible for a section 245A DRD are effectively not taken into account in determining the foreign tax credit limitation (i.e., the expenses do not reduce the taxpayer's foreign source income, or the numerator of the section 904 foreign tax credit limitation (FTC limitation), nor do the expenses reduce the taxpayer's "entire taxable income," or the denominator of the FTC limitation). However, these rules do not limit a taxpayer's deductions; the deductions allocable to the section 245A subgroup are removed from the FTC limitation calculation and the exempt asset rule reduces the amount of expenses apportioned to GILTI, causing more deductions to be apportioned to the taxpayer's other section 904 baskets or residual basket.

The proposed expansion of the application of section 265 would instead disallow these deductions and presumably rely on the existing section 861 expense allocation rules for allocating expenses to exempt income. In addition, to the extent taxpayers qualify for a section 250 deduction, CFC stock would no longer be treated in part as an exempt asset under section 864(e)(3) because a portion of the deductions allocated to the GILTI basket would be disallowed under the broader section 265 application. Similarly, since deductions allocated to the section 254A subgroup would also be disallowed under section 265, section 904(b)(4) would be repealed. The proposal anticipates further rules for determining the amount of disallowance in the case only partial deductions are allowed under section 245A or section 250.

Read a May 31, 2021 KPMG report on the FY 2022 Green Book proposals for additional analysis and observations: **KPMG report: Analysis and observations of tax proposals in Biden Administration's FY 2022 budget** [PDF 1.4 MB] (116 pages).

The Green Book's proposal would be effective for tax years beginning after December 31, 2024.

Limit the ability of domestic corporations to expatriate

The Green Book's anti-inversion proposal is substantially a reintroduced proposal. [Read **KPMG report: Analysis and observations of tax proposals in Biden Administration's FY 2022 budget** [PDF 1.4 MB] (116 pages).] In general, the proposal would reduce the ownership percentage for a complete inversion (when the foreign acquirer is treated as a domestic corporation for U.S. tax purposes) from at least 80% to greater than 50% and would eliminate the current-law 60% test for surrogate foreign corporations. The proposal would also expand the scope of an inversion to include certain asset acquisitions consisting of substantially all of a trade or business. The proposal clarifies that additional regulatory authority would be granted to exempt certain internal restructurings involving partnerships from the application of section 7874 and to define a trade or business for purposes of section 7874.

The Green Book's proposal would be effective for transactions that are completed after the date of enactment.

Disallow stock losses attributable to foreign income that was taxed at a reduced rate

In determining a U.S. shareholder's loss on the disposition of stock of a CFC, the proposal would require a U.S. shareholder to reduce its basis in the shares of a CFC (but not below zero) by the amount of deductions relating to GILTI or section 965 income inclusions that were attributable to the stock.

Under current law, a U.S. shareholder is entitled to a dollar-for-dollar basis increase equal to the full amount of the subpart F or GILTI inclusion, notwithstanding the fact that the U.S. shareholder might have been entitled to a section 250 or a section 965 deduction as a result of that inclusion. The failure to take these deductions into account in determining the U.S. shareholder's basis in a CFC can cause a U.S. shareholder to recognize a loss that is arguably inappropriate.

The proposal would also require basis adjustments with respect to stock or other property through which the U.S. shareholder owns the CFC stock (such as, for example, stock in another CFC), as well as stock or other property that has a basis determined with respect to the CFC stock.

The proposal would apply to dispositions occurring on or after the date of enactment regardless of whether the deduction under section 250 or 965(c) was claimed in tax years prior to such date.

KPMG observation

Existing section 961(d) already requires basis reductions to eliminate losses with respect to a dividends-received reduction under section 245A. This proposal would expand the Section 961(d) concept to eliminate losses with respect to deductions under section 250 or section 965(c). Like section 961(d), it would eliminate losses, but it would not cause a reduction in gains.

Expand the definition of foreign business entity to include taxable units

The Green Book's proposal to expand information reporting for foreign business entities under section 6038 to each separate taxable unit of a corporation or partnership is substantially a reintroduced proposal. [Read **KPMG report: International tax proposals in Biden Administration's budget for FY 2023** [PDF 1.5 MB]] This information reporting proposal substantially would align information reporting requirements with the substantive changes described above that determine CFC and foreign branch income and credits on a country-by-country basis. The proposal would also provide that the accounting period for a taxable unit that is a branch or disregarded entity is the same as the accounting period of its owner, unless otherwise provided for by the Secretary.

The Green Book's proposal would apply to tax years of controlling U.S. persons beginning after December 31, 2024, and to annual accounting periods of foreign business entities ending with or within the tax year of such controlling U.S. person.

Adopt the undertaxed profits rule

The Green Book's proposal to repeal BEAT and adopt an undertaxed profits rule (as well as a domestic minimum top-up tax) is substantively identical to the same proposals in prior Biden Administration Green Books. The UTPR proposal is intended to align the U.S. rules with the UTPR included in the OECD Pillar Two global anti-base erosion (GloBE) rules. Generally, the proposed UTPR would apply to foreign-parented financial reporting groups that have global annual revenue of €750 million or more in at least two of the prior four years. Since the UTPR would not apply with respect to income that is subject to an IIR that is consistent with the Pillar Two GloBE rules (which would include income subject to GILTI, as modified by the Green Book proposals), the UTPR generally would not apply to U.S.-parented multinationals.

Under the proposal, the UTPR would apply a top-up tax by reference to low-taxed income of foreign entities and foreign branches (on a jurisdiction-by-jurisdiction basis) and coordinate the allocation of the top-up tax among all jurisdictions (including the U.S.) with a Qualified UTPR. The proposal would disallow U.S. tax deductions of U.S. corporations and U.S. branches of foreign corporations, to the extent necessary to collect the hypothetical amount of top-up tax required for the financial reporting group to pay an ETR of at least 15% in each profitable foreign jurisdiction. The disallowance of U.S. tax deductions would not apply to reduce COGS and would disallow both related party and unrelated party deductions when a foreign affiliate is low-taxed (unlike BEAT, which aims to prevent base erosion of U.S. earned income through related-party deductible payments).

The proposal would also introduce a domestic minimum top-up tax that would apply to U.S. profits when a UTPR in another jurisdiction comes into effect. The domestic minimum top-up tax would equal the excess of (1) 15% of the financial reporting group's U.S. profit over (2) all the group's income tax paid or accrued with respect to U.S. profits (including federal and state income taxes, corporate AMT, and creditable foreign income taxes incurred with respect to U.S. profits). The proposal explicitly provides that when a UTPR in another jurisdiction comes into effect, the proposal would ensure taxpayers continue to benefit from tax credits and certain other tax incentives.

For a more detailed discussion, read a KPMG report on the FY 2023 Green Book international tax proposals: **KPMG report: International tax proposals in Biden Administration's budget for FY 2023** (March 28, 2022).

The Green Book's proposal would be effective for tax years beginning after December 31, 2024.

Repeal the deduction for foreign-derived intangible income

The Green Book would repeal the deduction for foreign-derived intangible income (FDII), effective for tax years beginning after December 31, 2023. The proposal would redeploy the revenue raised by repealing FDII to directly incentivize research and development (R&D) in the United States but does not include a specific proposal for the enhanced R&D incentive. The Green Book's proposal is substantially a reintroduced proposal to repeal the deduction for FDII. [Read a May 31, 2021 KPMG report on the FY 2022 Green Book proposals: **KPMG report: Analysis and observations of tax proposals in Biden Administration's FY 2022 budget** [PDF 1.4 MB] (116 pages).]

The proposed repeal would be effective for tax years beginning after December 31, 2024.

Revise the rules that allocate Subpart F income and GILTI between taxpayers to ensure that Subpart F income and GILTI are fully taxed

The Green Book would modify the existing pro rata share rules for determining subpart F inclusions and GILTI inclusions for U.S. shareholders of CFCs. The proposal is substantially similar to a proposal in the House-approved BBBA, including the revised framework for determining a U.S. shareholder's pro rata share for CFC shares directly or indirectly owned on the last relevant day and the new rules for CFC shares directly or indirectly owned during the year but not on the last relevant day. [Read a **KPMG report** [PDF 2.4 MB] (210 pages) dated November 19, 2021 that provides analysis and observations about the similar proposal in the House-approved BBBA.] The changes from the House-approved BBBA primarily relate to determining certain current year dividend amounts that would impact the pro rata share calculation and the Secretary's grants of authority. The changes include:

- The definition of "nontaxed current dividends" would be revised to (1) include dividends paid to a U.S. shareholder that would qualify for a dividends received deduction, rather than only a section 245A(a) deduction; and (2) provide authority for the Secretary to include dividends paid to upper-tier CFCs, presumably including dividends paid to upper-tier CFCs that are not included in subpart F income as a result of the high-tax exception, same-country dividend exception, or the look-through rule of section 954(c)(6)

- The definition of pre-holding period dividends, which can reduce the pro rata share amount for shares directly or indirect owned by a U.S. shareholder on the last relevant day, would be revised by adding authority for the Secretary to include dividends of current year earnings and profits paid to another CFC

- The Secretary's grant of authority would be expanded to include issuing guidance that: (i) treats distributions and other amounts as dividends or not as dividends; and (ii) requires (in addition to allowing) a foreign corporation to close its books upon a change in ownership for purposes of determining pro rata share.

The proposal would apply to tax years of foreign corporations that begin after the date of enactment, and tax years of U.S. shareholders that end with or within such year.

Require a controlled foreign corporation's tax year to match that of its majority U.S. shareholder

The Green Book's proposal is similar to the BBBA proposal that would repeal the election allowing specified foreign corporations to use a tax year beginning one month earlier than the majority U.S. shareholder's tax year ("one-month deferral rule"). [Read a **KPMG report** [PDF 2.4 MB] (210 pages) dated November 19, 2021 that discussing the similar proposal in the House-approved BBBA.] Generally, under section 898(c) a specified foreign corporation (i.e., a CFC in which a U.S. shareholder owns on each testing day more than 50% of stock in the CFC, by vote or value) is required to follow the tax year of its majority U.S. shareholder. However, section 898(c)(2) provides an exception permitting a specified foreign corporation to elect the one-month deferral rule. Like the BBBA, the Green Book proposal would eliminate the election under section 898(c)(2) for a CFC to use a tax year that is different from its majority U.S. shareholder's tax year.

The BBBA provided a special transition rule under which specified corporations with existing one-month deferrals would have, for their first tax year beginning after November 30, 2022, a one-month short year to conform the majority U.S. shareholder's year. Similarly, under the Green Book's proposal, CFCs with existing elections would also have a short tax year as of the first tax year end of its majority U.S. shareholder, following at least 60 days after enactment of the Green Book proposal.

The Green Book proposal would be effective as of the date of enactment.

Limit foreign tax credits from sales of hybrid entities

The Green Book's proposal is substantively similar to the proposal in the BBBA that would extend the principles of section 338(h)(16) to a "covered asset disposition." In general, section 338(h)(16) applies to disregard the results of a section 338 deemed asset sale (which occurs when a section 338 election is made in connection with a qualified stock purchase) for purposes of determining the source and character of items in applying the foreign tax credit rules. A covered asset disposition is a direct or indirect disposition of an entity that is treated as a corporation for foreign tax purposes but as a partnership or disregarded entity for U.S. tax purposes and to entity classification changes that are not recognized for foreign tax purposes. Similar to existing section 338(h)(16), the proposal would limit taxpayers' control over the source and character of income generated in connection with a transaction that is an asset sale for federal income tax purposes. [Read a **KPMG report** [PDF 2.4 MB] (210 pages) dated November 19, 2021 that provides analysis and observations about the similar proposal in the House-approved BBBA.]

The proposal would be effective for transactions occurring after the date of enactment.

Restrict deductions of excessive interest of members of financial reporting groups

The Green Book's proposal is similar to the House-passed BBBA proposal that limits disproportionate interest expense in the United States. [Read a **KPMG report** [PDF 2.4 MB] (210 pages) dated November 19, 2021 that provides analysis and observations about the similar proposal in the House-approved BBBA.] In general, the proposal would limit a taxpayer's deductible interest expense if the taxpayer is a member of a multinational group and is considered to have disproportionate net interest expense in the United States compared to the rest of its worldwide group.

Unlike the BBBA proposal, and similar to a reintroduced proposal, this year's proposal allows for excess limitation to be carried forward for three years. The proposal also has a safe harbor that allows a group to apply section 163(j), substituting 10% for 30%. This approach also applies to a corporation that cannot substantiate its share of its financial reporting group interest limitation. Any disallowed interest expense can be carried forward indefinitely. [Read a **KPMG report: Analysis and observations of tax proposals in Biden Administration's FY 2022 budget** [PDF 1.4 MB] (116 pages).]

The Green Book's proposal would be effective for tax years beginning after December 31, 2024.

Conform scope of portfolio interest exclusion for 10% shareholders to other tax rules

The Green Book's proposal is similar to the proposal in the BBBA that would expand the definition of a 10% shareholder of an issuing corporation. The proposed definition would also include any person who owns 10% or more of the total value of the stock of the corporation issuing the obligation. [Read a November 2021 **KPMG report** [PDF 2.4 MB] (210 pages) on BBBA tax proposals, including modifications to the portfolio interest exclusion.] Generally, portfolio interest is excluded from the withholding tax, under section 871, on certain U.S.-source fixed or determinable annual or periodical income (FDAP) that is not effectively connected income. Under current law, portfolio interest does not include interest payments received by a 10% shareholder, defined as a person who owns 10% or more of the total combined voting power of all classes of voting-stock of a corporation. Like the BBBA proposal, the Green Book's proposal would modify this definition to also include any person who owns 10% or more of the total value of the stock of the issuing corporation. Additionally, like the BBBA proposal, the Green Book proposal would only modify the definition of a 10% shareholder with respect to a corporation but would not alter the definition of a 10% shareholder of a partnership. This proposal would closely align the definition of a 10% shareholder, in the case of interest paid on obligations issued by corporations, to the definition of a U.S. shareholder in section 951(b).

The Green Book's proposal would apply to U.S.-source interest payments made on debt instruments issued (or deemed issued) 60 or more days after the date of enactment.

Treat payments substituting for partnership effectively connected income as U.S. source dividends

The Green Book proposal is similar to the proposal in the House-passed BBBA that imposes withholding tax on payments substituting for partnership effectively connected income (ECI). [Read a November 2021 **KPMG report** [PDF 2.4 MB] (210 pages) on BBBA tax proposals in the House bill.] The Green Book proposal contains less detail than the legislative text that passed the House of Representatives regarding the scope of derivative financial instruments covered and the payments subject to tax. In addition, the proposal may be narrower than the House-passed bill because it does not explicitly apply to gain on the sale or exchange of derivative financial instruments and is limited to payments determined by reference to partnership ECI (potentially excluding payments that refer to income taxable to a foreign partner other than ECI). Like the House-passed bill, the Green Book proposal provides regulatory authority to carry out the purposes of the section.

The proposal would be effective tax years beginning after December 31, 2024.

Expand access to retroactive qualified electing fund elections

The Green Book proposal to permit a retroactive QEF election to the extent prescribed by the Secretary in regulations is substantively a reintroduced proposal from previous year Green Books. Under the proposal, the existing statutory timing rules for making QEF elections would be replaced with a grant of regulatory authority allowing QEF elections to be made in the time and manner prescribed in the regulations and generally would remove the current restrictions limiting the circumstances in which taxpayers can make a retroactive QEF election. [Read a KPMG report (May 31, 2022) on the FY 2023 Green Book proposals: **KPMG report: Analysis and observations of tax proposals in Biden Administration's FY 2022 budget** [PDF 1.4 MB] (116 pages).]

For a detailed discussion of this proposal, see Kevin. M. Cunningham, Expanding Access to Retroactive QEFs: a Biden Proposal That Deserves a Swift Enactment, *Tax Notes International,* November 14, 2022, p.847.

The proposal would be effective on the date of enactment and anticipates regulations or other guidance permitting taxpayers to amend previously filed returns for open years.

Reform taxation of foreign fossil fuel income

The Green Book's proposed changes with respect to foreign oil and gas extraction income and foreign oil related income, as well as proposed amendments to section 901(n) to codify the regulatory "dual capacity taxpayer" rules, are substantively identical to those proposed in the BBBA. [Read a KPMG report (September 16, 2021) on the BBBA tax proposals: **KPMG report: "Build Back Better Act" tax proposals, as approved by Ways and Means** [PDF 2.3 MB] (203 pages).] Notably, the proposal would repeal the exemption from GILTI for FOGEI, and expand the definition of FOGEI and FORI to include income derived from shale oil and tar sands activity.

The Green Book's proposals would be effective for tax years beginning after December 31, 2024.

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

The Green Book's proposal to incentivize onshoring while eliminating tax deductions for offshoring is substantially a reintroduced proposal. [Read **KPMG report: Analysis and observations of tax proposals in Biden Administration's FY 2022 budget** [PDF 1.4 MB] (116 pages).] The proposal would create a new general business credit equal to 10% of eligible expenses paid or incurred in connection with onshoring a U.S. trade or business. The action must result in an increase in U.S. jobs. Eligible expenses incurred by a foreign affiliate of a U.S. taxpayer would result in a credit for the U.S. taxpayer.

The proposal would also disallow deductions for expenses paid or incurred in connection with offshoring a U.S. trade or business. The action must result in a loss of U.S. jobs. Further, no deduction would be allowed against a U.S. shareholder's GILTI or Subpart F income inclusions for any expenses paid or incurred in connection with moving a U.S. trade or business outside the United States.

Creditable expenses 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.

Support housing and urban development

Make permanent the new markets tax credit and formalize allocation incentives for investing in areas of higher distress

The administration's proposal would permanently extend the new markets tax credit (NMTC), with a new allocation for each year after 2025 of $5 billion, indexed for inflation after 2026.

In addition, the proposal would add a third allocation priority to favor qualified community development entities (CDEs) that intend to concentrate their qualified low-income community investments on populations, geographies, and/or businesses that are identified by the Secretary as having significantly deeper levels of economic distress.

The proposal would be effective after the date of enactment.

KPMG observation

The NMTC, which is currently extended until 2025, would be made permanent, providing greater certainty and planning opportunities for taxpayers who invest in NMTC projects located in economically underserved areas.

In addition, the new proposal to add a third statutory priority would create an incentive for CDEs to commit to targeting populations, geographies, and businesses experiencing economic distress during the competitive allocation process. The goal being that those communities most in need would be those primarily served by the NMTCs.

Provide a neighborhood homes credit

The administration's proposal would create a new allocated tax credit—the neighborhood homes credit (NHC)—to encourage (1) new construction for sale, (2) substantial rehabilitation for sale, and (3) substantial rehabilitation by existing homeowners who will remain in their communities.

Allocation of NHCs

Each state would create a new agency (or designate a pre-existing agency) to serve as the Neighborhood Homes Credit Agency (NHCA) to allocate potential NHICs to project sponsors. Sponsors seeking potential NHCs would apply to their state NHCA which would then choose the applications deemed best suited to achieving the program's goals. Each NHCA would be responsible for monitoring compliance with all provisions governing NHCs, for reporting violations to the IRS, and set standards developer fees, building quality, and development costs.

Each State would have a specified amount of potential NHCs to allocate each year. For 2025, each State could allocate the greater of $8 million or the product of $6 times the state's population.

The amounts would be indexed for inflation for subsequent years, and states would be able to carry forward any unallocated potential NHCs for up to three years. Additionally, any NHCs allocated to a project that are unused after five years are returned to the pool of potential credits for the NHCA to re-allocate within three years.

Project eligibility criteria

The homes being constructed or rehabilitated must meet the following criteria to be eligible for NHCs:

- The project must be a single-family home (including homes with up to four dwelling units), a condominium, or a residence in a housing cooperative.
- The project must be in an NHC neighborhood
- The project must be sold, or in the case of owner-rehabilitation projects completed, within five years of the allocation of the credit.
- After construction or rehabilitation, the home must be owned by an occupant who is an NHC qualified owner.

An NHC neighborhood is a low-income census tract that meets at one of three median income and median home value tests or is a census tract located in a disaster area.

A NHC qualified owner is someone who will use the home as their primary residence, whose household income does not exceed 140% of area/State median income, and in the case of a sale, is not related to the seller.

Determination of credit amount

The NHC amount generally would increase as development costs increase and decrease as sales proceeds (or owner payments, in the case of rehabilitation for current homeowners) increase. Construction costs are included in determining the NHC amount only to the extent they are incurred after an NHCA has allocated potential NHCs to the project, and acquisition costs for land and buildings are included to the extent they are incurred within three years prior to the allocation.

For home sales, the NHC would be limited to no more than the lesser of 35% of development costs and 28% of the national median sales price for new homes. The credit amount would phase out to zero as sales proceeds reach five times the area median family income, with an alternative phase out applying in the case of residences with more than one dwelling unit.

For the rehabilitation of an owner-occupied residence, the NHC would be limited to the lesser of $50,000 and 50% of rehabilitation costs.

Claiming the NHC

A taxpayer could claim NHCs only after construction and inspection are completed and the home is occupied by a NHC qualified owner. If, within five years of the last day of the calendar year in which the taxpayer became entitled to the NHC, the NHC qualified owner-occupant sells or rents the home, there may be NHC-related financial consequences to the owner-occupant. In the case of a sale, any gain from the sale would have to be paid to the NHCA, unless published Treasury guidance identifies situations when a smaller payment would be appropriate. In the case of renting during the five-year period, expenses with respect to the home would not be deductible against the owner's federal income taxes.

The Secretary would be given authority to prescribe rules to implement this provision.

The proposal would be effective for tax years beginning after December 31, 2024.

KPMG observation

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

Expand and enhance the low-income housing credit

The administration's proposal to expand and enhance the low-income housing tax credit (LIHTC) includes the following changes to the existing LIHTC program.

Increase the Annual HCDAs

The proposal would increase the annual housing credit dollar amounts (HCDAs). For 2025, each state would receive $4.37 per capita in new potential credits for allocation, subject to a minimum of $5,039,154 for smaller states. For 2026, the per capita and state minimum amounts would be $4.99 and $5,754,271, respectively. For 2027 and subsequent years, these amounts would be the amounts for the prior year, indexed for inflation as under current law.

Reduce the 50% PAB financing requirement

Currently, the 4% housing credit provides a credit from the State private activity bond (PAB) volume cap when 50% or more of the building and land is financed by tax-exempt bonds. The proposal would modify this requirement allowing a building to be eligible to earn LIHTCs on the basis of 25% (rather than 50%) PAB financing of the building and land.

This change would apply to buildings placed in service in tax years beginning after December 31, 2024.

Repeal the qualified contract provision

The proposal would eliminate the qualified contract exception for buildings receiving allocations after January 1, 2025.

Currently, 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 credit agency (HCA) find a qualified buyer to acquire the owner's building within a one-year period from the date of such request. If the HCA is unable to find a qualified buyer, the building's extended use period terminates, and the housing affordability restrictions are removed.

Specifically, the repeal of the qualified contract provision would not apply to a building if, before January 1, 2025: (1) the building received an allocation of HCDAs, or (2) in the case of a building some portion of which is financed with PABs subject to volume cap, the building received a determination that the LIHTCs received on account of the PAB financing would be necessary for the building's financial feasibility and continued viability, and that an allocation of HCDAs would have been permissible in the absence of PAB financing.

In addition, for buildings that continue to be subject to the qualified contract provision, a qualified contract submitted after the date of enactment must have an offer purchase price that is the sum of the fair market value of the non-low-income and low-income portions of the building taking into account requirements under LIHTC rules.

The proposal to repeal the qualified contract provision would apply from the date of enactment.

Repeal the ROFR safe harbor and replace it with an option safe harbor

Under current law, no federal income tax benefit shall fail to be allowable to the taxpayer with respect to any qualified low-income building merely by reason of a right of first refusal held by the tenants (or a tenant group), a resident management corporation of such building, a qualified nonprofit organization, or a government agency to purchase the property after the close of the initial compliance period for a price which is not less than a certain purchase price. The proposal would modify this right of first refusal safe harbor into an option to buy safe harbor. Only persons eligible under current law to hold a right of first refusal could be the holder(s) of the option.

To be eligible for the safe harbor, the option right to purchase would have to cover both the building and assets required for continued operation as affordable rental housing and/or remaining partnership interests in the building. Additionally, the option right to purchase would have to be exercisable regardless of the approval or non-approval of the current owner or related persons.

Finally, upon exercise of the option, the purchase price of the qualified low-income building would have to be at least the amount of the debt securing the building that was incurred more than five years before the sale. The contractual purchase price of any partnership interest(s) would have to be at least the partner's ratable share of such debt.

The proposals would apply to agreements entered into, or amended, after the date of enactment. The proposal notes that the administration would work with Congress to develop an approach appropriate for existing agreements.

KPMG observation

The proposal would be a significant expansion of the LIHTC, increasing the amount of the current credit available to support and expand affordable housing. The proposal 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.

In addition, the proposal would repeal the qualified contract option to preserve the affordability of the low-income project rather than allowing the project to become market rate at the end of the initial compliance period. Replacing the ROFR safe harbor with the option safe harbor also is intended to help preserve the affordability of the low-income project by removing the ability to impose potential hurdles to the use of ROFRs.

Modify energy taxes

Eliminate fossil fuel tax preferences

Enhanced oil recovery credit

The administration's proposal would repeal the section 43 credit for enhanced oil recovery (EOR) costs for tax years beginning after December 31, 2024.

The general business credit includes a 15% credit for eligible costs attributable to EOR projects located in the United States involving the application of specified tertiary recovery methods. The allowable credit may be phased out for a tax year if the annual reference price of oil published by the Treasury exceeds an inflation adjusted statutory threshold price.

KPMG observation

For many years, higher oil prices caused the EOR credit to be completely phased out. However, as oil prices have fallen from peak levels, the EOR credit has been available in several recent years. For example, the EOR credit was available for calendar years 2016-2018 and 2021. The credit was phased out for calendar years 2019, 2020, 2022, and 2023. If oil prices remain in line with 2023 prices, the repeal of the EOR credit would not impact taxpayers significantly. However, if oil prices decrease, the repeal of the EOR credit could have an impact.

Credit for oil and gas produced from marginal wells

The administration's proposal would repeal section 45I credit for oil and gas produced from marginal wells for tax years beginning after December 31, 2024.

The general business credit includes a credit for crude oil and natural gas produced from marginal wells. The credit generally has served as an incentive to continue to operate wells, despite low production volumes or when the wells primarily produce heavy oil. However, the allowable credit may be phased out for a tax year if the reference price of oil published by the Treasury exceeds a statutory threshold price.

KPMG observation

The statutory threshold price for the marginal well credit is set at a low enough level that the credit has been subject to significant phase out in recent years. In 2022 and 2023, the credit for oil and gas was completely phased out. As such, it is unlikely that the credit going forward would be a significant benefit, even if not repealed.

Expensing of domestic intangible drilling costs (IDCs)

The administration's proposal would repeal the section 263(c) deduction for IDCs for tax years beginning after December 31, 2024.

Section 263(c) and the regulations thereunder allow a deduction for all expenditures made by the holder of a working interest in a domestic oil and gas property for wages, fuel, repairs, hauling, supplies, and other expenses incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and natural gas. Generally, IDCs do not include expenses for items which have a salvage value or items related to the acquisition of the property. The deductibility of IDCs under section 263(c) is elective, meaning that taxpayers can choose to capitalize IDCs instead, recovering them through depletion or depreciation. Moreover, a taxpayer who elects to deduct IDCs has the additional option in any tax year of electing under section 59(e) to deduct a portion of its IDCs and capitalize the rest.

KPMG observation

The deductibility of domestic IDCs is one of the oldest provisions in the tax system, dating back to 1916. It has been a key component of the oil and gas tax rules for a century, and its repeal could have a significant impact on oil and gas producers. The administration's proposal estimates that the repeal of the IDC deduction would generate approximately $8.5 billion in additional tax revenue between FY 2024 and FY 2033. However, simply repealing such a well-established provision without also providing for the expected treatment of those expenditures going forward leaves substantial uncertainty for taxpayers (and likely the IRS) to sort out. IDC is an umbrella term that covers several categories of expenditures, some of which may still be deductible (such as wages), may be capitalized to depreciable equipment (and possibly eligible for bonus depreciation), or may be capitalized to the depletable basis of the property. Moreover, the percentage of a taxpayer's IDCs falling into each category may vary greatly depending on the location of the reservoir, particularly when comparing on-shore and off-shore drilling.

Treasury may find that providing guidance that helps draw lines between those categories would reduce the burden of the repeal on examination teams.

What is also left unclear in the proposal is what the administration's plan is with respect to foreign IDCs, and whether the administration might choose to replace section 263(c) with a rule similar to the existing rule for foreign IDCs. Under section 263(i), IDCs paid or incurred with respect to wells located outside of the United States are not deductible. However, a taxpayer has the option of either capitalizing foreign IDCs into the depletable basis of the oil and gas property or amortizing the foreign IDCs over a 10-year period. Given that no changes were proposed with respect to section 263(i), it is possible that a similar amortization option could be provided for domestic IDCs, which would also have the benefit of providing certainty on the treatment of domestic IDCs going forward.

Deduction for costs paid or incurred for any tertiary injectant used as part of a tertiary recovery method

The administration's proposal would repeal the deduction under section 193 for costs paid or incurred for any tertiary injectant used as part of a tertiary recovery method for tax years beginning after December 31, 2024.

Section 193 provides that amounts paid or incurred for qualified tertiary injectants are deductible. Qualified tertiary injectants are used as a part of a tertiary recovery method to increase the recovery of crude oil, excluding any recoverable hydrocarbon injectants. The deduction may be subject to recapture upon a disposition of the property.

KPMG observation

The administration's proposal does not provide any guidance on the intended treatment of tertiary injectant expenditures following the possible repeal of section 193. Section 193 was enacted to resolve uncertainty as to the proper treatment of tertiary injectant expenditures, and it is hoped that further guidance would be provided if legislative text is eventually drafted. Specifically, query whether the cost of the tertiary injectants would be capitalized to the basis of the property and recoverable under cost depletion. Given the high cost of operating tertiary recovery projects, without a cost recovery mechanism for injectant expenditures these projects may no longer be economically viable for many taxpayers.

Exception to passive loss limitations provided to working interests in oil and natural gas properties

The administration's proposal would repeal the exception under section 469(c)(3) to the passive loss limitation rules for working interests in oil and natural gas properties for tax years beginning after December 31, 2024.

Generally, section 469 denies taxpayers the ability to deduct losses from passive activities. When the taxpayer does not materially participate in a trade or business, section 469 requires losses from the business to be carried forward until the taxpayer has sufficient income from passive sources to offset them. However, section 469(c)(3) provides an exception to the general passive activity rules when a taxpayer holds a working interest in oil or gas property. Under section 469(c)(3)(A), the exception applies both when the taxpayer holds their share of the working interest directly and when the working interest is held through an entity such as a partnership (provided that the entity does not limit the taxpayer's liability with respect to the working interest). Therefore, as explained in section 469(c)(4), a taxpayer is not required to meet the material participation rules in the case of an investment in a working interest in oil or gas property. The administration's proposal would appear to treat an investment in a working interest in oil or gas property on par with other passive investments.

Percentage depletion with respect to oil and gas wells section 263A

The administration's proposal would repeal the use of percentage depletion with respect to oil and gas wells for tax years beginning after December 31, 2024.

The basis in oil and gas property is recovered through depletion. There are two methods for determining a taxpayer's depletion deduction for the tax year, with the taxpayer generally following the method which produces the larger depletion deduction for a given year. Cost depletion is determined by figuring out what percentage of the total recoverable reserves were recovered from the property during the tax year, with the taxpayer recovering a ratable portion of the tax basis in the property. In contrast, percentage depletion is based on a percentage of the taxpayer's gross income realized from the property for the tax year. Because the calculation of the percentage depletion deduction is not a function of the taxpayer's remaining tax basis in the property, a taxpayer may be allowed to claim percentage depletion in excess of their tax basis in the property. If the administration's proposal were enacted, cost depletion would be the only method of determining a taxpayer's depletion deduction for oil and gas property.

KPMG observation

Percentage depletion on oil and gas property has been limited to independent producers and royalty owners since 1975. Presently, the independent producer and royalty owner exception allows taxpayers who are neither retailers nor refiners to deduct percentage depletion on a maximum of 1,000 barrels of oil or natural gas equivalents per day. Given the relatively low cap on a taxpayer's share of production to qualify for the independent producer exception, the administration's proposal is unlikely to have a meaningful impact on larger producers.

However, the elimination of percentage depletion may impact smaller outside investors in oil and gas properties, including those investing through funds, which have been an important source of capital for the industry. If the administration's proposal is adopted, the repeal of percentage depletion (along with many of the other oil and gas proposals discussed herein) could make the oil and gas sector a less attractive investment option and impact the ability to raise capital for future developments.

Geological and geophysical expenditures

Geological and geophysical expenditures are costs incurred for the purpose of obtaining and accumulating data that will serve as the basis for the acquisition and retention of mineral properties. The administration's proposal would repeal the two-year amortization of geological and geophysical expenditures under section 167(h) for independent producers and replace it with the same seven-year amortization period currently used by major integrated oil and gas producers for tax years beginning after December 31, 2024.

KPMG observation

It is noteworthy that the administration chose to retain the favorable treatment afforded by section 167(h), albeit with the extended recovery period currently available to integrated producers, rather than simply repealing section 167(h) as it proposed with other oil and gas provisions. The enactment of section 167(h) was an attempt to settle an area of significant uncertainty and reduce the burden on examination teams. While section 167(h) has not eliminated all uncertainty in this area, it likely still provides sufficient value to taxpayers and the government alike that the administration would not propose a repeal.

Expensing of mine exploration costs and development costs

The administration's proposal would repeal the election to deduct amounts paid or incurred for mine exploration under section 617 and mine development under section 616 for tax years beginning after December 31, 2024.

Under section 617 and section 616, a taxpayer is allowed a deduction both for the costs incurred in determining whether and where to mine an ore or mineral deposit as well as for the costs incurred in preparing the mine site for production. Under the existing law, if a taxpayer does not elect to deduct exploration and development costs, the amounts paid or incurred are capitalized to the basis of the mineral property and recovered through depletion. Presumably, if the administration's proposal were enacted, this would become the proper treatment of all exploration and development expenditures.

Percentage depletion for hard mineral fossil fuels

The administration's proposal would repeal percentage depletion for hard mineral fossil fuels for tax years beginning after December 31, 2024.

The basis in mineral property is recovered through depletion. There are two methods for determining a taxpayer's depletion deduction for the tax year, with the taxpayer generally following the method which produces the larger depletion deduction for a given year. Cost depletion is determined by figuring out what percentage of the total recoverable mineral reserves were recovered from the property during the tax year, with the taxpayer recovering a ratable portion of the tax basis in the property. In contrast, percentage depletion is based on a percentage of the taxpayer's gross income realized from the property for the tax year. Because the calculation of the percentage depletion deduction is not a function of the taxpayer's remaining tax basis in the property, a taxpayer may be allowed to claim percentage depletion in excess of their tax basis in the property. If the administration's proposal were enacted, cost depletion would be the only method of determining a taxpayer's depletion deduction for hard mineral property that produces what is considered a fossil fuel.

KPMG observation

The administration's proposal does not specify that it is intended to apply only to coal production. The introductory language to the section of the Green Book outlining the administration's fossil fuel proposals lists oil, gas, and coal production as its intended subjects. However, the description of the proposal itself states that it is aimed at "coal mines and other hard-mineral fossil-fuel properties," which raises the question of what other hard minerals are to be considered fossil fuels and would be covered by this proposal.

Capital gains treatment for royalties

The administration's proposal would repeal capital gains treatment under section 631(c) for amounts realized in tax years beginning after December 31, 2024, from royalties received on the disposition of coal or lignite ore, regardless of when the property generating these royalties was acquired.

Under current section 631(c), a taxpayer who retains a royalty in connection with the disposal of coal (including lignite) or iron ore may treat the royalty payments as proceeds from the sale of the coal or iron ore. The result is that the royalty payments generate capital gain, rather than ordinary income. Moreover, despite being an economic interest in coal or iron ore, the royalty income is not subject to depletion. Under the administration's proposal, future royalty payments on sales of coal (including lignite) would appear to generate ordinary income instead of capital gain. The proposal does not appear to impact the current treatment under section 631(c) for retained iron ore royalties.

KPMG observation

A retained royalty is an economic interest in the mineral, despite the treatment provided for by section 631(c). This raises the question of what the result would be if section 631(c) were repealed as proposed, but the administration was unsuccessful in repealing percentage depletion for coal. Does converting the section 631(c) retained royalty into a traditional economic interest then allow the taxpayer to take percentage depletion on the royalty income (assuming that all of the taxpayer's tax basis in the property had been recovered already, such that cost depletion would be unavailable)?

Further, section 631(c) treats a retained royalty as more akin to an installment sale of the mineral property than as a traditional royalty. This treatment may leave several questions unanswered. For example, does a possible repeal of section 631(c) for coal (including lignite) open the door for taxpayers simply structuring their transactions aiming for installment sale treatment? Would exam teams be burdened with determining when a series of sales payments are properly viewed as a royalty?

Publicly traded partnerships

The administration's proposal would repeal the exemption from the corporate income tax for publicly traded partnerships (PTPs) with qualifying income and gains from activities relating to fossil fuels. The repeal would be effective for tax years beginning after December 31, 2029.

KPMG observation

PTPs generally are classified as corporations for tax purposes. However, section 7704 provides an exception for PTPs that derive at least 90% of their gross income either from industries that had traditionally organized as partnerships or from passive investment assets that the investors could have acquired directly. The natural resources extractive industries have been one of the activities which generate income that satisfies the 90% test, allowing natural resource PTPs to continue to qualify as passthrough entities under section 7704. In addition to the lack of a corporate-level tax on the business, investors in natural resources PTPs have benefitted from the flow through of depletion and depreciation deductions as an offset to their allocations of operating income. The public investors have received reliable distributions of the cash generated by partnership operations, with relatively small allocations of net taxable income.

While several natural resources PTPs incorporated after the reduction in corporate rates, most have still found passthrough status to be an attractive way of raising capital for future acquisitions and development. If this proposal were enacted, particularly in combination with an increase in the corporate rates, query whether the natural resources PTP market itself might evaporate and whether many of the existing companies might find their operations no longer economically viable. However, with a proposed effective date five years in the future, the industry would have a long lead time to prepare.

Amortization of air pollution control facilities

The administration's proposal would repeal accelerated amortization for air pollution control facilities for tax years beginning after December 31, 2024.

Section 169 provides for an 84-month recovery for certain pollution control facilities placed in service at coal-fired power plants after April 11, 2005. Eligible pollution control facilities under section 169 include new identifiable treatment facilities which are used, in connection with a plant or other property, to abate or control water or atmospheric pollution by removing, altering, disposing, storing, or preventing the creation or emission of pollutants, contaminants, wastes, or heat. Without this special treatment, these facilities would be subject to a 39-year recovery life.

Eliminate drawbacks on petroleum taxes that finance the Oil Spill Liability Trust Fund and Superfund

The administration's proposal would remove from eligibility for drawback under 19 U.S.C section 1313, the excise taxes imposed by section 4611 effective for exports after December 31, 2024.

Section 4611 imposes excise tax on crude oil and imported petroleum products, including crude, to help fund the Oil Spill Liability Trust Fund (OSLTF) and the Hazardous Substances Superfund (Superfund). The rate of tax per barrel is the sum of the $0.09 OSLTF financing rate and the inflation-adjusted $0.164 Superfund financing rate. The revenues from the OSLTF generally pay costs associated with damages resulting from oil spills. The revenues from the Superfund generally are available for expenditures incurred in connection with releases of hazardous substances into the environment.

U.S. Code Title 19 (Customs Duties), section 1313 – Drawbacks and Refunds has been interpreted to allow drawback of the excise tax (a rebate of taxes paid when goods are imported and then exported again) when products are exported, even if the exports are exempt from the tax. The drawback is allowed when the product is exported even though the is no concomitant reduction in the risk of an oil spill or release of a hazardous substance.

A prohibition on the drawbacks of the tax would strengthen the finances of the OSLTF and the Superfund and remove an incentive to export crude and other imported petroleum products.

KPMG observation

As noted in a footnote in the Green Book, in *Trafigura Trading, LLC v. United States*, 29 F.4th 286 (5th Cir. 2022), the court held that imposing the section 4611 tax on crude oil exported from the United States violates the Export Clause of the U.S. Constitution. Another court has interpreted drawback to be available even based on an export not subject to tax; thus, untaxed crude exports could be the basis for section 4611 drawback claims on imported crude. The proposal would not affect the holding of *Trafigura Trading*.

Impose digital asset mining energy excise tax

Current law does not impose an excise tax on digital asset mining energy use, although there are certain rules relating to broker reporting and reporting of cash transactions. Digital asset mining is a process for validating transactions among holders of digital assets to record and transfer cryptographically secured assets on a distributed ledger by, for example, using high-powered computers to perform calculations to select the validator. The computational effort involved in mining can be substantial and can therefore require a correspondingly large amount of energy and negative environmental effects. To address the increase in energy consumption attributable to the growth of digital asset mining and uncertainty and risks to local utilities and communities, the proposal would impose an excise tax on electricity usage by digital asset miners.

The proposal would impose an excise tax on any firm using computing resources, whether owned by the firm or leased from others, to mine digital assets. The excise tax would be equal to 30% of the costs of electricity used in digital asset mining. Firms engaged in digital asset mining would be required to report the amount and type of electricity used as well as the value of that electricity, if purchased externally. Firms that lease computational capacity would be required to report the value of the electricity used by the lessor firm attributable to the leased capacity, which would serve as the tax base. Firms that produce or acquire power off-grid, for example by using the output of a particular electricity generating plant, would be subject to an excise tax equal to 30% of estimated electricity costs. For this purpose, except as otherwise provided by the Secretary, the term “digital asset” means any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary.

The proposal would be effective for tax years beginning after December 31, 2024. The excise tax would be phased in over three years at a rate of 10% in the first year, 20% in the second, and 30% thereafter.

KPMG observation

The proposal would, for the first time, impose an excise tax on energy consumption used by computing resources to mine digital assets equal to 30% of the costs of electricity used in digital asset mining. The proposal includes different tax computations, depending on whether the energy consumer is the purchaser or lessor, and whether the power is produced or acquired off-grid.

Strengthen taxation of high-income taxpayers

Apply the net investment income tax to pass-through business income of high-income taxpayers

Under current rules, individuals with income greater than $200,000 (or $250,000, in the case of a joint return) are subject to a 3.8% tax on net investment income. Net investment income tax (NIIT) does not currently apply to self-employment earnings. Self-employment earnings and wages are subject to either self-employment (SECA) tax or Federal Insurance Contributions Act (FICA) tax on earnings up to an indexed cap ($168,600, for 2024). These amounts are also subject to a 2.9% Medicare tax that is not subject to any cap and an additional 0.9% Medicare tax is imposed on self-employment earnings of high-income taxpayers, together totaling 3.8%. The administration's proposal would subject all pass-through business income of high-income taxpayers to either NIIT or SECA tax. This would be accomplished in part by expanding the definition of net investment income to potentially include gross income and gain from any trade or business not already subject to NIIT or SECA tax for high-income taxpayers.

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

The proposal would be effective for tax years after December 31, 2023, and would require the revenue from NIIT to be directed to the Medicare trust fund (also known as the Hospital Insurance Trust Fund) in the same manner as the current revenue from FICA and SECA taxes.

KPMG observation

The proposal calls for a significant shift from current law for the taxation of limited partners. The benefit of the limited partner exception would effectively apply only in cases when a limited partner is not a high-income taxpayer. The proposal appears to rely on the material participation rules of section 469. These changes, if adopted, likely would have a significant impact on structuring and controls around monitoring of partner activities. For example, the reliance on material participation rules may place a renewed focus on the grouping of activities.

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

The expansion of the definition of net investment income to include gross income and gain from any trade or business not otherwise subject to self-employment taxes would impose NIIT on the rental income and gain derived in a trade or business of high-income real estate professionals. Under the proposal, while the income of high-income taxpayers may be subject to a 3.8% tax under either SECA or NIIT, the classification as self-employment income rather than net investment income may still have an impact on the taxpayer's overall tax liability for the year. For example, tax from SECA may be partially deductible, whereas tax from NII would not. Or, for example, the taxpayer may be able to use losses generated by activities subject to SECA tax to offset income subject to SECA tax or use losses generated by activites subject to NIIT to offset income suject to NIIT, but cannot use SECA losses to offset NIIT income and vice versa.

Increase the net investment income tax rate and additional Medicare tax rate for high-income taxpayers

Under current section 1411, a tax is imposed on net investment income (NII) in the case of certain individuals, estates, or trusts. In general, for individuals, the tax is 3.8% of the lesser of net investment income or the excess of modified adjusted gross income (AGI) over a threshold amount. The present threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case. The net investment income tax (NIIT) does not apply to self-employment earnings.

Also, under current rules, self-employment earnings and wages are subject to either the Self-Employment Contributions Act (SECA) tax or the Federal Insurance Contributions Act (FICA) tax, respectively. Both SECA and FICA taxes apply at a rate of 12.4% for social security tax on earnings up to an indexed cap ($160,200 for 2023) and at a rate of 2.9% for Medicare tax on earnings (not subject to a cap). An additional 0.9% Medicare tax is imposed on self-employment earnings and wages of high-income taxpayers, bringing the combined rate of Medicare tax to 3.8% for these taxpayers.

The proposal would increase the NIIT rate by 1.2 percentage points for taxpayers with more than $400,000 of income, bringing the marginal NIIT rate to 5% for investment income above the threshold. This threshold would be indexed for inflation.

The proposal would also increase the additional Medicare tax rate by 1.2 percentage points for taxpayers with more than $400,000 of earning. When combined with current-law tax rates, this would bring the marginal Medicare tax rate up to 5% for earnings above the threshold. The threshold would likewise be indexed for inflation.

The two proposals above would be effective for tax years after December 31, 2023, and would require the revenue from these proposals, as well as the revenue from the NIIT under current law, to be directed to the Medicare trust fund (also known as the Hospital Insurance Trust Fund)

KPMG observation

When combined with the proposal to "Incease the net investment income tax rate and additional Medicare tax rate for high-income taxpayers" described above, the two proposals would have the effect of increasing the rate at which NII and Medicare income is taxed. When combined, the collective proposals impacting NIIT and Medicare taxes are projected to generate additional revenue for the government of approximately $814 billion (for the fiscal year periods from 2024-2034).

Increase the top marginal income tax rate for high-income earners

The administration's proposal would increase the top marginal individual income tax rate from its current level of 37% to 39.6%.

Under current law applicable to tax year 2024, the 37% top marginal individual income tax rate currently in effect applies to taxable income over $731,200 for married individuals filing a joint return and surviving spouses, $609,350 for unmarried individuals (other than surviving spouses), $609,350 for head of household filers, and $365,600 for married individuals filing a separate return.

Under the proposal, the 39.6% top marginal individual income tax rate would apply to taxable income over $450,000 for married individuals filing a joint return, $400,000 for unmarried individuals (other than surviving spouses), $425,000 for head of household filers, and $225,000 for married individuals filing a separate return for tax year 2024. The income brackets subject to the top marginal individual income tax rate would be indexed for inflation after the 2024 tax year.

This proposal would be effective for tax years beginning after December 31, 2023.

KPMG observation

This proposal is substantially similar to previous administration proposals.

The TCJA temporarily reduced the top marginal individual income tax rate from 39.6% to 37% for tax years 2018 through 2025. This reduced rate is set to expire and to revert to 39.6% after December 31, 2025. The administration's proposal would accelerate the date the TCJA's reduced rate is scheduled to sunset to tax years beginning after December 31, 2023. In addition to restoring the top marginal individual income tax rate to its pre-TCJA level, the proposal would lower the top income bracket threshold to a level that is lower than the level that was in effect for the 2017 tax year.

While the administration's proposal would increase the top marginal individual income tax rate to 39.6%, taxpayers in the highest income tax bracket would still receive the full tax benefit of their itemized deductions. The proposal does not include a limit on itemized deductions for high-income earners.

In addition, the Green Book does not include a proposal to repeal or modify the $10,000 aggregate limitation imposed by the TCJA on the itemized deduction for state and local income taxes, property taxes, and sales tax (SALT deduction) for tax years 2018 through 2025.

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

Reform the taxation of capital income

Tax capital income for high-income earners at ordinary rates

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

The administration's proposal would increase the tax rate on long-term capital gains and qualified dividends for high-income taxpayers by taxing such income at ordinary income tax rates for taxpayers with adjusted gross income (AGI) in excess of $1,000,000 ($500,000 for married filing separate taxpayers), but only to the extent that the taxpayer's taxable income exceeds that threshold, with amounts indexed for inflation after 2024.

The proposal would be effective for gains required to be recognized and for dividends received on or after the date of enactment.

KPMG observation

This proposal is substantially similar to a previous administration proposal.

The proposal would be effective for gains required to be recognized and for dividends received on or after the date of enactment, which could be during the tax year. As a result, a taxpayer with AGI in excess of $1 million may be subject to two different tax rates during the year of enactment: the taxpayer would be subject to a top tax rate of 20% (23.8% including the NIIT) on long-term capital gain and qualified dividend income recognized on or before the date of enactment, and 37% (40.8% including the NIIT) on long-term capital gain and qualified dividend income recognized after the date of enactment. That same taxpayer would be subject to a top tax rate of 39.6% (44.6 % including the NIIT) on long-term capital gain and qualified dividend income recognized during the tax year of enactment, assuming the administration's separate proposals that would increase the top ordinary individual income tax rate to 39.6% and the NIIT rate to 5% for tax years beginning after December 31, 2023, were enacted as well.

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

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

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

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

KPMG observation

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

KPMG observation

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

KPMG observation

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

KPMG example

Taxpayer has previously fully utilized his gift and estate tax lifetime exemption amount. At Taxpayer's death in 2025, he owns stock worth $10 million with zero basis. If the deemed realization proposal is enacted (as well as the proposals to increase capital gain rates to match ordinary income rates, to increase the top ordinary income rate to 39.6%, and to increase the net investment income rate to 5%), Taxpayer would be subject to tax on the $10 million of gain (assuming exclusions do not apply) at 44.6% and his estate would pay $4.46 million in income tax. After taking the proposed deduction for such income tax in calculating the estate tax, the Taxpayer would be left with a taxable estate of $5.54 million which would be taxed at 40%, resulting in estate tax liability of $2.216 million. The Taxpayer's effective tax rate would be 66.76% leaving $3.324 million for his heirs.

Assume instead that in 2025 Taxpayer decided to gift the shares to his heirs prior to death and has previously fully utilized his gift and estate tax lifetime exemption amount. Taxpayer would again have $10 million of gain (assuming exclusions do not apply) taxed at 44.6% and the Taxpayer would owe $4.46 million in income tax. The administration's proposal does not appear to provide any deduction for that income tax in calculating the Taxpayer's gift tax liability. As a result, the Taxpayer would also owe $4 million in gift tax ($10 million taxed at 40%). Taxpayer's effective tax rate for the gift would appear to be 84.6%.

The proposal would also require unrealized gain in assets owned by a trust, partnership, or other non-corporate entity to be recognized if the property had not been the subject of a recognition event within the prior 90 years, and such testing would apply to property held on or after January 1, 1944, that is not subject to a recognition event after December 31, 1943. Accordingly, a recognition event would not occur under this provision until December 31, 2033.

KPMG observation

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

KPMG observation

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

Under the proposal, a transfer would be defined and valued using the gift and estate tax provisions. However, in determining the capital gains tax due, a transferred partial interest in property would be valued as a "proportional share of the fair market value of the entire property" except to the extent of assets actively used in the conduct of a trade or business.

KPMG observation

For purposes of calculating the capital gains realized on a transfer of a partial interest in property, the proposal appears to be an attempt to limit or eliminate valuation discounts, including those for lack of marketability or lack of control, at least for entities owning passive investments.

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

KPMG observation

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

KPMG observation

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

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

Even if this particular proposal is not intended to affect the foregoing transactions, the Green Book includes another proposal that would treat the transfer of an asset for consideration between a grantor trust (other than a revocable trust) and its grantor-owner as one that is regarded for income tax purposes, which would result in the seller recognizing gain on any appreciation in the transferred asset and the buyer owning the asset with a basis equal to the value of the asset at the time of the transfer. (See below discussion of the proposal entitled "Transfers for consideration between a grantor trust and its grantor-owner".)

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

KPMG observation

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

KPMG observation

One of the current benefits of a charitable remainder trust (CRT) is the ability to transfer appreciated assets into the trust and have the trust sell the assets and reinvest the proceeds without immediate income tax consequences. Because the trust is a tax-exempt entity, the gain is not subject to tax unless and until a distribution is made, allowing 100% of the value of the assets to appreciate further inside the trust for the benefit of the donor and charity. If the proposal became law, a contribution of appreciated assets to a CRT which is set up to provide the minimum required actuarial amount of 10% for the charitable remainderman while the donor retains the other 90%, might cause the donor to realize 90% of the total gain making such contributions far less tax efficient. However, it is unclear whether the definition of transfer would include incomplete gifts or not; if not, then creating a CRT in which the donor retains a 90% interest may still provide income tax benefits. Since charitable lead trusts (CLT) are typically zeroed out—i.e., the value of any remainder for the grantor's children is zero based on the required assumptions—the grantor might be able to exclude 100% of the gain on the appreciated assets used to fund the CLT since that would be the portion attributable to the charitable beneficiary.

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

Finally, the proposal would allow each person a $5 million exclusion for other unrealized capital gains on property transferred by gift or held at death. This lifetime exclusion would be indexed for inflation and would be portable to a surviving spouse (making the exclusion $10 million per couple).

The administration's proposal provides that the recipient's basis in property, whether received by gift or by reason of the decedent's death would be the property's fair market value at the time of the gift or the decedent's death.

KPMG observation

While not completely clear, it appears that the recipient would hold the gifted/inherited assets with a fair market value basis even if an exclusion applied that allowed the donor/decedent to avoid paying tax on the transfer.

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

KPMG observation

Although the 15-year payment plan provision only appears to apply to transfers at death, the family business deferral provision is more broadly stated such that it may be intended to apply to gifts or bequests of family business interests as well. These relief provisions would need to be significantly expanded upon to address all the potential issues they raise. It is possible that the details might resemble parts or all the current rules regarding the deferral of estate tax attributable to inclusion of closely held business interests in a decedent's estate.

The proposal would be effective for gains on property transferred by gift, and on property owned at death by decedents dying, after December 31, 2024, and on certain property owned by trusts, partnerships, and other non-corporate entities on January 1, 2025. This proposal is substantially similar to the proposal included in prior Green Books.

Impose a minimum income tax on the wealthiest taxpayers

The proposal would impose a minimum tax of 25% on total income (generally including unrealized capital gains) on taxpayers with wealth (assets minus liabilities) of more than $100 million. Uncredited prepayments of the minimum tax would be available as a credit against subsequent taxes on realized capital gains to avoid double taxation of the same gain.

Taxpayers would have the option to pay the first year of minimum tax liability in nine equal, annual installments, and for subsequent years, the minimum tax could be paid in five equal, annual installments. Under the proposal, the minimum tax liability calculation would follow a phase-in mechanism for taxpayers with wealth between $100 million and $200 million. The tax liability would be limited to 50% times the amount by which the taxpayer's wealth exceeds $100 million. As a result, the minimum tax would be fully phased in for all taxpayers with wealth greater than $200 million.

Under this proposal, if a single taxpayer who was subject to the minimum tax dies and has paid more in prepayments than their tax liability from gains at death, the excess would be refunded. The refund would go to the decedent's estate and would be included in the estate for federal estate tax purposes. For married taxpayers, any unused prepayments would be transferred to the surviving spouse.

To implement this tax, taxpayers with wealth greater than the $100 million threshold would be required to report annually to the IRS the total basis and total estimated value, as of December 31 of each tax year, of their assets in each specified asset class, and the total amount of their liabilities. Based on this reporting, taxpayers who are illiquid may elect to include in the calculation of their minimum tax liability unrealized gain in only tradeable assets. However, making this election would subject the taxpayer to a deferral charge of up to 10% of unrealized gains.

Tradable assets would be valued using end-of-year market prices, while non-tradable assets would be valued using various methods, including the greater of original or adjusted cost basis, the last valuation event, or other methods approved by the Secretary.

The proposal would be effective for tax years after December 31, 2024.

KPMG observation

This proposal is substantially similar to the one previously proposed by the administration. As in previous years, the proposal introduces a significant change in the tax landscape for high-wealth individuals, imposing a minimum tax on total income, including unrealized capital gains.

The requirement for annual reporting to the IRS would increase administrative burdens for high-wealth individuals. The valuation of tradable and non-tradable assets could also present challenges, particularly for those with a high proportion of non-tradable assets.

Modify rules relating to retirement plans

Prevent excessive accumulations by high-income taxpayers in tax-favored retirement accounts and make other reforms

Special distribution rules for high-income taxpayers with large retirement account balances

The proposal requires distributions from retirement account balances in excess of $10 million for high income earners, who are individuals with adjusted taxable income in excess of $400,000, joint income of $450,000, or $425,000 for head of household. All qualified retirement plans and eligible deferred compensation plans would be treated as one plan.

Accounts that exceed $10 million as of the last day of the preceding calendar year would be required to distribute a minimum of 50% of the excess. Further, accounts with greater than $20 million would be subject to an additional required distribution floor of the lesser of:

- That excess above $20 million
- The portion of the taxpayers' aggregate vested account balance that is held in a Roth IRA or designated Roth account

Allocation of the distribution among plans would be at the discretion of the participant, but allocations subject to the additional required distribution floor must apply first to Roth amounts in Roth IRAs and then to Roth designated accounts.

Under the proposal, the distributions required are treated as an increase to the required minimum distributions (RMDs) for purposes of the excise tax on failure to take RMDs. Excise tax for failure to take a distribution is 25% but can be reduced to 10% if the failure is corrected within a specified period.

Under the proposal, an individual with $10 million in vested account balances could not make additional contributions to an IRA or such contribution would be treated as an excess contribution subject to a 6% excise tax.

Under the proposal, such required distributions would not be eligible for rollover distribution treatment.

Section 72(t)(2) is proposed to be amended to exempt 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.

A plan administrator would be required to report the vested account balance of any participant or beneficiary with a vested balance that exceeds $2.5 million. The report would separately report the vested balance held in a designated Roth account and the portion in other accounts.

These provisions are proposed to be effective for tax years beginning after December 31, 2024. However, the requirement that a plan administrator report vested account balance above $2.5 million would be effective for plan years beginning after December 31, 2025.

KPMG observation

These provisions are very similar to the Mega-IRA proposals in the “Build Back Better Act.” Due to the $10 million threshold, the contribution and distribution requirements would not likely affect the majority of retirement plan participants.

Limit rollovers and conversions to designated Roth retirement accounts and Roth IRAs

The proposal would prohibit high-income earners, who are individuals with adjusted taxable income in excess of $400,000, joint income of $450,000, or $425,000 for head of household, from rolling over or converting amounts held in a non-Roth designated account to a Roth account. The prohibition applies to rollovers and distributions from an employer plan to a Roth IRA, as well as from conversions within an employer plan or from a non-Roth IRA to a Roth IRA.

This is proposed to be effective for tax years and distributions beginning after December 31, 2024.

KPMG observation

This proposal would eliminate the commonly used “backdoor” Roth conversion for all high-income earners. Backdoor conversions would still be allowed for taxpayers with income above the Roth IRA contribution limit, but below the high-income earner limit. However, this proposal does not appear to limit Roth contributions in employer retirement plans, but the conversion for amounts originally contributed pre-tax.

Prohibited transactions relating to holding DISC or FSC in individual retirement account

The U.S. tax system has 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 proposal would prohibit an IRA from holding an interest in a DISC or FSC that receives a payment from an entity, which is also owned by the IRA owner. Whether an entity is owned by the IRA owner is determined under section 318 constructive ownership rules by substituting 10% for 50%.

The sanction would be the same as the prohibited transaction sanction for an IRA owner (i.e., deemed to have distributed all assets on the first day of the tax year).

The proposal would be effective for interests in DISCs and FSCs acquired or held after December 31, 2024.

Statute of limitations with respect to IRA noncompliance

The proposal would extend the statute of limitations (SOL) from three to six years for additional tax assessments on prohibited transactions and erroneous information reporting relating to investment valuation in an IRA. This proposal is retroactive and would extend the SOL to six years for taxes with respect to which the three-year SOL ends (without regard to the amendment made by this proposal) after December 31, 2024. A similar proposal has been included in prior Green Books by the administration.

Support workers, families, and economic security

Expand the child credit, and make permanent full refundability and advanceability

For tax years 2024 and 2025, the proposal would increase the maximum child tax credit (CTC) per child to $3,600 for qualifying children under age six and to $3,000 for all other qualifying children, phase-out the portion of the credit in excess of $2,000 for taxpayers with modified AGI in excess of $150,000 for married taxpayers filing jointly, $112,500 for head of household filers, and $75,000 for all other taxpayers, and increase the maximum age to qualify for the CTC from 16 to 17.

The proposal would also make the CTC fully refundable (regardless of earned income) starting in tax year 2024 and would make additional changes to implement an advance payment program for tax years beginning after December 31, 2024.

Additionally, the proposal would reform the annual tax credit to allow for monthly tax credits to be known as "monthly specified child allowances." A taxpayer's eligibility for, and the amount of, the credit would both be determined on a monthly basis. In determining eligibility for the credit, the proposal would replace the historical "qualifying child" eligibility standard with the "specified child" standard which focuses primarily on the source of care for the child.

The proposal would introduce a "presumptive eligibility" concept, which would be used to determine when a taxpayer is eligible to claim the monthly specified child allowance or receive a monthly advance child payment. During a period of presumptive eligibility, the proposal would prohibit the child from being a specified child of any other taxpayer who has not established presumptive eligibility. The proposal also would require the Secretary to issue guidance for procedures to establish automatic presumptive eligibility and provide automatic grace periods for taxpayers who fail to establish presumptive eligibility in a timely manner to receive monthly specified child allowances or retroactive payments.

The proposal would require the Secretary to establish a program for making "monthly advance child payments" to be disbursed electronically. A monthly advance child payment would be equal to the taxpayer's monthly specified child allowance. The annual total of specified child allowances to which a taxpayer would be entitled would be compared with the annual total of advance child payments received on the taxpayer's federal income tax return. Taxpayers could claim an additional credit if they had not received the total specified child allowances that they were entitled to and would be required to make a repayment if they had received more than they should have. The proposal would require taxpayers to repay any excess monthly advance child payments due to changes in filing status, change in income, and understatements of income.

Additional proposed changes include an online portal to facilitate sharing of information between taxpayers and the IRS, streamlined processes to address claims by multiple taxpayers for the same specified child, and rules to address potential abuses.

The proposed changes to the maximum credit amounts, phase-out thresholds, age requirements, and refundability would be effective for all tax years beginning after December 31, 2023, and, except for refundability, would expire for tax years beginning after December 31, 2025. The proposed changes related to the implementation of the advance monthly payment program would be effective for all tax years beginning after December 31, 2024.

Restore and make permanent the American Rescue Plan expansion of the earned income tax credit for workers without qualifying children

The earned income tax credit (EITC) is a refundable credit intended to support low- to moderate-income working families. Eligibility for the EITC is based on a worker's family size, filing status, age, adjusted gross income, investment income, earned income, and U.S. immigration and work status. Under the current rules, the EITC provides little or no assistance to individuals at or near the poverty line and age restrictions prevent young workers and older workers from claiming the EITC. Under the American Rescue Plan Act of 2021 (ARPA) several temporary changes were made to the EITC including expanding the credit for workers without qualifying children, lowering the minimum age for eligibility, eliminating the maximum age limit for eligibility and increasing the income thresholds.

The proposal would restore for 2024 and make permanent the increase in the EITC parameters for workers without children introduced by ARPA. The end of the phase-in threshold and the end of the plateau (when additional dollars of earned income or AGI have no effect on the size of the credit) would be indexed for inflation in the same way as the other EITC parameters. The proposal would also restore for 2024 and make permanent the ARPA expansion of age eligibility. Under the proposal, the taxpayer must be at least 19 years old or at least 24 if a full-time student. In the case of married taxpayers filing jointly, the credit could be claimed if at least one spouse is over age 19 (or at least 24 if a full-time student). Former foster children and qualified homeless individuals would be eligible at 18, regardless of student status. The proposal would eliminate the maximum age at which a taxpayer may claim the credit.

The proposal would be effective for tax years beginning after December 31, 2023.

KPMG observation

The proposal was previously presented by the administration.

The proposal is intended to allow more workers without children to qualify for the EITC by increasing the income thresholds and expanding the age range for eligibility.

Make permanent the Inflation Reduction Act expansion of health insurance premium tax credits

The premium tax credit (PTC) is provided to certain individuals who purchase health insurance through a marketplace exchange under the Affordable Care Act of 2010. The PTC is a refundable credit and may be payable in advance directly to the insurer. Eligibility for advance payments of the PTC is based on the household income and family size. A taxpayer's PTC is equal to the lesser of the amount of their health insurance premium or the amount by which a benchmark plan premium exceeds the taxpayer's "required contribution" (i.e., a percentage of household income). The ARPA decreased the percentages used to calculate the required contribution and extended PTC eligibility to taxpayers with household income above 400% of the federal poverty line for tax years 2021 and 2022. The "Inflation Reduction Act of 2022" (IRA) extended the ARPA changes through tax year 2025. Prior to ARPA, the required contribution percentages were indexed for inflation but fixing those percentages through 2025 effectively paused the indexation.

The proposal would make the ARPA and IRA decrease in the percentages used to calculate the required contribution permanent and permanently repeal the indexation of those percentages. In addition, the proposal would make permanent the extended PTC eligibility to taxpayers with household income above 400% of the federal poverty line. The proposal would be effective for tax years beginning after December 31, 2025.

KPMG observation

The proposals to reduce the percentage of annual income that households are required to contribute toward the premium and extend eligibility for the credit to taxpayers with household income above 400% of the federal poverty line have been previously presented by the administration. In addition, one previous proposal provided that the applicable contribution percentages would not be indexed until 2027 but under the current proposal, the indexing would be permanently repealed.

The proposal is intended to allow more taxpayers to qualify for the PTC thus reducing the cost of health insurance coverage for a wider range of income levels.

Make the adoption tax credit refundable and allow certain guardianship arrangements to qualify

The proposal would make the adoption credit fully refundable. Under current law, taxpayers who claim an adoption credit but do not have sufficient tax liability to benefit from the full amount of the credit are able to carry the credit amount forward for up to five years. Any portion of the adoption credit carryforward that cannot be used in those five years would expire unused. Under this proposal, taxpayers who have unexpired adoption credit carryforwards would be able to claim the full amount of those carryforwards on their 2025 returns. Unused carryforwards that expired before 2025 would not be eligible for claim.

The proposal also would allow families who enter a guardianship arrangement with a child that meets certain requirements to claim a refundable credit for the expenses related to establishing the guardianship relationship. For a guardianship arrangement to be eligible for this credit:

1) The relationship must be established by court order
2) The arrangement must not be with the guardian’s own child or stepchild
3) The guardian and the child must meet a residency requirement
4) The child must be under age 18 at the time the relationship is established

If the child is later adopted by the guardian, expenses eligible for the adoption credit would be reduced by any guardianship expenses already claimed.

The proposal would grant regulatory authority to the Secretary to develop rules and reporting requirements.

The proposal would be effective for tax years beginning after December 31, 2024.

KPMG observation

This proposal has previously been presented by the administration.

The adoption credit is non-refundable under current law. Low- and moderate-income families may not have sufficient tax liability to utilize the full amount of an adoption credit and may not benefit from some or all of the credit to which they are entitled. If the adoption credit is made refundable, the tax benefit will be guaranteed for families regardless of tax liability. In addition, the tax benefit would lower the cost of an adoption for more families.

In some cases, a family may wish to assume legal and financial responsibility for a child through a guardianship rather than an adoption. The credit for expenses related to guardianships is intended to offset the cost of establishing the guardianship and may provide more families with the financial ability to provide for children in need.

Make permanent the income exclusion for forgiven student debt

Forgiven or otherwise discharged loan amounts are gross income to the borrower and subject to individual income tax in the year of discharge, unless an exception applies. The American Rescue Plan Act of 2021 (ARPA) provided an exception to the treatment of forgiven loan amounts as gross income for certain qualifying student debt that is discharged after December 31, 2020, and before January 1, 2026. During this period, forgiven student loans will be excluded from gross income and therefore not subject to taxation.

Like previous proposals, the current proposal would make this exception permanent. The types of student loans that are eligible for the exclusion include loans made expressly for post-secondary education expenses if the loan was made, insured or guaranteed by a federal, state or local government entity or eligible educational institution; private education loans; and certain loans made by educational and tax-exempt organizations.

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

KPMG observation

Prior to the ARPA, many types of federal student loan forgiveness were already excluded from gross income. The expansion of the types of student debt that will qualify for income exclusion when forgiven is intended to provide more consistency in the treatment of debt forgiveness.

Extend tax-preferred treatment to certain federal and tribal scholarship and education loan programs

Scholarship income

Although “qualified scholarship” amounts (certain scholarship amounts that are used to pay tuition, required fees and related expenses such as books, computers, etc.) are generally not included in gross income, scholarship amounts that are used to pay other expenses (e.g., childcare and travel), or that represent payment for services that are required as a condition for receiving the scholarship, are considered ordinary income and are taxable. However, individuals who receive scholarships for services from certain organizations that provide care or assistance to underserved populations are not taxed on those scholarships. The proposal would extend this preferred tax treatment to other federal and tribal organizations that also provide care or assistance to underserved populations but are not currently included within the exception.

Education loans repaid on another’s behalf

Loan amounts that are repaid on behalf of another individual are considered ordinary income and are taxable unless excepted. Debt that is repaid under certain programs intended to increase the availability of heath care services in underserved areas and certain work-related loan forgiveness programs are among the exceptions. The proposal would extend this preferred tax treatment to additional loan repayment programs similar to the ones currently receiving favorable treatment.

Support for underserved communities

The proposal would also provide that Segal AmeriCorps Education Awards (Segal Awards) that are used for current education expenses would be treated like scholarships even though the awards represent payment for services. Awards used to repay student loans or transferred awards would also be excluded.

The proposal would be effective for tax years beginning after December 31, 2024.

KPMG observation

There are several federal and tribal loan repayment and scholarship programs that are similar to the programs listed as an exception but do not currently receive preferred tax treatment. As a result, participants in similar programs may be receiving very different tax treatment with respect to scholarships and loan forgiveness. By adding these programs as exceptions, the participants in programs with very similar purposes will be treated similarly.

Segal Awards may only be used for education purposes—either for current expenses or loan repayment. Since these awards are similar to scholarships and loan repayment programs that receive preferred tax treatment, recipients of these awards would be able to benefit from the same tax treatment under this proposal.

Increase the employer-provided childcare tax credit for businesses

The proposal would increase the section 45F credit for qualified childcare expenses from 25% to 50% for the first $1 million of qualified care expenses. For small businesses, the credit would be increased to 60% of the first $1 million of qualified care expenses. In addition, the proposal would increase the maximum credit limitation from $150,000 to $500,000 (and $600,000 for small businesses). The credit related to referral expenses would remain at 10% of the first $1.5 million of referral expenses. The section 45F credit generally applies to amounts paid or incurred for the operating costs or under a contract with a qualified childcare facility or to acquire, construct, rehabilitate, or expand property which is to be used as part of a qualified childcare facility by the taxpayer.

The proposal is effective for tax years beginning after December 31, 2024.

The JCT has estimated that the proposal will decrease revenues by $393 million over 10 years.

KPMG observation

Prior proposals have included similar increases in credit, but for a temporary two-year period.

Improve the design of the work opportunity tax credit to promote longer-term employment

The administration's proposal would modify the design of the work opportunity tax credit (WOTC) to promote longer-term employment. This proposed change would be effective for individuals hired after December 31, 2024.

The WOTC is currently available for employers who are hiring individuals from one or more of 10 targeted groups and is generally equal to 40% of qualified wages paid during the first year of employment (i.e., first-year wages). The WOTC does not presently apply to wages paid to individuals who work fewer than 120 hours in the first year of service and is reduced to 25% if the individual works at least 120 hours, but less than 400 hours.

The allowance of the reduced 25% credit may encourage the hiring of temporary employees, contrary to the goal of WOTC of providing long-term employment opportunities to members of targeted groups. Accordingly, the proposal would increase the minimum number of hours worked by an individual in the first year of service to become eligible for the WOTC from 120 hours to 400 hours, thus eliminating the 25% credit for employees who work between 120 and 400 hours.

Provide tax credits for certain first-time homebuyers and home sellers

The administration's proposal includes two new refundable tax credits intended to support homeownership: a refundable credit for qualified first-time homebuyers and a refundable credit for qualified home sellers.

Homebuyer credit

The first-time homebuyer credit would be equal to 10% of the purchase price of a home, up to a maximum credit of $10,000. Except for married individuals filing separately, the credit would phase out for taxpayers with modified AGI between $100,000 and $200,000.

A first-time homebuyer eligible for the credit would be a natural person who purchases a home as a principal residence from an unrelated party and had no ownership interest in any other principal residence during the tax year in which the purchase was made or during the prior three tax years. The home purchased would be required to be in the United States.

Half of the purchaser's credit would be applied to the return for the tax year in which the home was purchased, and the other half of the credit would be applied to the return for the following year.

To claim the credit, a taxpayer must (1) begin using the home as a principal residence no later than 120 days following the purchase, (2) own the home and be using the home as a principal residence on the date on which they file that year's federal income tax return, and (3) provide the IRS certain information from the settlement statement used to complete the home purchase. In addition, the taxpayer must continue to use the home as a principal residence during the three years following the purchase, or there would be a recapture event.

The tax credit would be available for home purchases after December 31, 2023, and before January 1, 2026.

Home seller credit

The home seller credit would be equal to 10% of the sales price of a home, up to a maximum credit of $10,000. A home seller is a natural person who sells a home to an unrelated party and had an ownership interest in a home during the tax year of the sale and during the prior tax year.

In general, the credit would be subject to phase out for taxpayers with modified AGI between $100,000 to $200,000. The credit would also phase out based on the sales price of the home for homes sold at a sales price between 80%-100% of the area median price.

For the sale to qualify for the credit, the home must be in the United States, and the buyer must be a natural person and attest that they intend to own the home and use it as a primary residence for at least one year.

The seller credit would apply to the return for the tax year in which the home was sold. The seller tax credit would be available for homes sold after December 31, 2023, and before January 1, 2025.

KPMG observation

This proposal introduces two new credits available for a limited amount of time, intended to open the availability of affordable housing by offsetting increased interest rates with a refundable tax credit.

Modify estate and gift taxation

KPMG observation

The Green Book did not contain any proposed changes to the estate, gift or generation-skipping transfer tax rates or the enhanced lifetime exemption amount (currently $13.61 million per individual). Under current law, the enhanced exemption amount will return to $5 million (indexed for inflation) in 2026. However, the administration did propose treating transfers of appreciated property by gift or bequest as realization events as part of its proposal to "Reform the taxation of capital income" discussed above.

Improve tax administration for trusts and decedents' estates

Expand definition of executor

The current statutory definition of "executor" only applies for estate tax purposes. This can cause various administrative issues because there may be no one who can represent the estate with respect to income tax liabilities and reporting obligations, or there may be multiple individuals who meet the definition. This proposal would move the existing definition of executor from section 2203 to section 7701, expressly making it applicable for all tax purposes, and would authorize such an executor to do anything on behalf of the decedent in connection with the decedent's pre-death tax liabilities or other tax obligations that the decedent could have done if still living. The proposal also would grant regulatory authority to the Secretary to adopt rules to resolve conflicts among multiple executors authorized by that provision. The proposal would apply upon enactment, regardless of a decedent's date of death. This proposal is substantially similar to the proposal included in the prior two Green Books.

Increase the limit on reduction in value of special use property

Generally, the value of property included in a decedent's estate for estate tax purposes is its "fair market value." Section 2032A allows the estate to elect to value certain real property used in farming or other trades or businesses at its current use (rather than other more valuable uses the property might be put to in the hands of a willing buyer). Under current law, the allowed valuation reduction (attributable to value at current use) is limited to $750,000 (or $1,390,000, as adjusted for inflation to 2024). The proposal would increase the permitted valuation reduction to a maximum of $14,000,000. This provision would be effective for estates of decedents dying on or after the date of enactment. This proposal is substantially similar to the proposal included in the prior two Green Books.

KPMG observation

Opponents of the estate tax often express concern that it may require farmers and small business owners to sell the business or farm in order to pay the estate tax. This can be even more of an issue when the "highest and best use" of real property owned by the decedent (or his business) may be in developing it rather than using it for its current use as a farm or ranch or timberland such that the estate tax value significantly exceeds its special use value. This proposal enhances the estate tax benefits of section 2032A for this group of taxpayers and appears to be a relief measure for farmers and small business owners.

Extend 10-year duration for certain estate and gift tax liens

Current law provides for an automatic 10-year lien on all gifts made by a donor and generally on all property in a decedent's estate to enforce the collection of gift and estate tax liabilities from the donor or the decedent's estate, as applicable. This lien cannot be extended, even when the IRS allows the tax to be paid over a timeframe that extends beyond 10 years. The proposal would extend the duration of the automatic lien beyond the current 10-year period to continue during any deferral or installment period for unpaid estate and gift taxes. The proposal would apply to 10-year liens already in effect on the date of enactment, as well as to the automatic lien on gifts made and the estates of decedents dying on or after the date of enactment. This proposal is substantially similar to the proposal included in the prior two Green Books.

Require reporting of estimated total value of trust assets and other information about the trust

This proposal would require certain trusts to report certain information to the IRS on an annual basis, including the name, address, and TIN of each trustee and grantor of the trust, and general information regarding the nature and estimated total value of the trust's assets. This reporting requirement would apply to each trust whose estimated total value on the last day of the tax year exceeds $300,000 (indexed for inflation) or whose gross income for the tax year exceeds $10,000 (indexed for inflation).

This proposal would also require trusts (in this case, regardless of value or income) to report the inclusion ratio of the trust for generation-skipping transfer (GST) tax purposes at the time of any distribution to a non-skip person as well as information regarding any trust modification or transaction with another trust. This information would allow the IRS and the taxpayer to verify the GST tax effect of contributions to and distributions from the trust without requiring a review of multiple years' records to determine that information. The proposal would apply for tax years ending after date of enactment.

This proposal is substantially similar to the proposal included in the prior two Green Books.

KPMG observation

It is unclear what specific concern the proposal relating to GST tax is intended to address. One possibility is that it relates to the new proposal (described below) requiring redetermination of a trust's inclusion ratio when the trust purchases assets from, or an interest in, another trust. The reporting of the inclusion ratio at the time of a distribution to a non-skip person is curious given that distributions to non-skip persons are not subject to GST tax and do not impact the trust's inclusion ratio. Perhaps part of the focus is on the potential loss of exempt status due to a trust modification or decanting. Or perhaps this is merely a way to encourage contemporaneous tracking of changes to the trust's inclusion ratio caused by additional contributions given the long history associated with many trusts today.

Require that a defined value formula clause be based on a variable that does not require IRS involvement

When gifting or selling hard-to-value assets (such as interests in a closely held business) taxpayers are often concerned about unanticipated gift tax exposure when the assumed value at the time of transfer ends up being lower than the value that is ultimately determined by the IRS and the courts. For example, the donor may want to utilize his/her lifetime gift tax exemption ($13,610,000 for 2024), but not pay gift tax on any overage. Formula clauses have become increasingly popular in recent years as a way for taxpayers to avoid this risk of unanticipated gift tax exposure. These formula clauses take different forms but typically limit any potentially taxable gift to a certain defined value/dollar amount (e.g., the number of units equal in value to $X) “as finally determined for federal gift tax purposes”.

The proposal would provide that if a gift or bequest uses a defined value formula clause that determines value based on the result of involvement of the IRS (which would seem to cover situations when the formula uses the “as finally determined for federal gift tax purposes” verbiage), then the value of such gift or bequest will be deemed to be the value as reported on the corresponding gift or estate tax return. On the other hand, the formula clause would be effective if the unknown value is determinable by an appraisal that occurs within a reasonably short period of time after the transfer, or the clause is used to define a marital or exemption equivalent bequest at death. The proposal would apply to transfers by gift or on death occurring after December 31, 2024. This proposal is substantially similar to the proposal included in last year’s Green Book.

KPMG observation

The IRS has argued that formula clauses should not be respected, in part because they make examination of the gift tax return and litigation by the IRS cost-ineffective. However, the courts have been more receptive to formula clauses and taxpayers have prevailed in many cases. If enacted, this proposal would appear to make formula clauses (at least the most popular and effective variety described above) void.

KPMG observation

The effective date for this proposal is December 31, 2024, instead of the more typical “date of enactment”. If the proposal were enacted before the indicated date, there might be a window of opportunity for taxpayers to make effective formula clause gifts prior to the end of the calendar year.

Simplify the exclusion from the gift tax for annual gifts

The gift tax does not apply to the first $18,000 of present interest gifts made to each donee (during 2024). As a contribution to a trust for the benefit of a donee does not normally meet the present interest requirement, taxpayers often give the trust beneficiaries rights to withdraw their share of the contribution for some limited period of time (known as “Crummey powers”); if timely notice of the right to withdraw is provided to the beneficiaries, the annual exclusion may then become available. Although there are clearly benefits to using Crummey powers and many trusts incorporate them, ensuring their effectiveness adds administrative complexity. In addition, Crummey powers are often granted primarily to avoid gift tax rather than with an intent that the beneficiary exercises their right to withdraw a contribution.

The proposal would eliminate the gift tax annual exclusion’s present interest requirement with respect to certain gifts. It would create a new category of transfers including transfers in trust, transfers of interests in passthrough entities, transfers of interests subject to a prohibition on sale, partial interests in property, and other transfers of property that, without regard to withdrawal, put, or other such rights in the donee, cannot immediately be liquidated by the donee. The proposal would impose an annual limit per donor of $50,000 (indexed for inflation) on transfers of property within this new category that will qualify for the annual exclusion. This proposal is substantially similar to the provision included in last year's Green Book. The proposal would be effective for gifts made after December 31, 2024.

KPMG observation

It is unclear how the overlap between the current annual exclusion of $18,000 per donee and this new annual exclusion of $50,000 will operate. The proposal seems to eliminate the benefits of using *Crummey* powers to secure the annual exclusion for transfers in trust. Under the proposal, transfers in trust need not qualify as gifts of a present interest but such transfers will only be excludable from the reach of the gift tax up to a maximum of $50,000 in value regardless of how many beneficiaries the trust has. This $50,000 limit would also apply to gifts of interests in passthrough entities (even when such gifts are made outright rather than in trust and regardless of how many donees are involved). However, the proposal appears to continue to allow for the exclusion from gift tax for outright gifts of cash and other liquid assets up to the current $18,000 per donee limit. Since the GST tax annual exclusion provisions of the Internal Revenue Code (Code) include a cross-reference to the gift tax annual exclusion, presumably the proposal would impact the availability of the GST tax annual exclusion in a similar manner.

Limit duration of generation-skipping transfer tax exemption

GST tax is imposed on gifts and bequests to transferees who are two or more generations younger than the transferor (e.g., the transferor's grandchildren). Each person has a GST exemption ($13.61 million for 2024) that can be allocated to transfers made to such "skip persons", whether outright or in trust. The allocation of GST exemption to a transfer excludes from the GST tax not only the amount of the assets equal to the exemption allocated, but also all appreciation and income on that amount. Many states have repealed limitations on the duration of trusts and now allow them to continue in perpetuity, resulting in an expansion of the transfer tax shield provided by the GST exemption.

The proposal would provide that the GST exemption would apply only to: (a) direct skips and taxable distributions to beneficiaries no more than two generations below the transferor, and to younger generation beneficiaries who were alive at the creation of the trust; and (b) taxable terminations occurring while any person described in (a) is a beneficiary of the trust. Solely for purposes of determining the duration of the exemption, a pre-enactment trust would be deemed to have been created on the date of enactment and, in this case, the proposal would provide that the grantor is deemed to be the transferor and, in the generation, immediately above the oldest generation of trust beneficiaries in existence on the date of enactment. Specifically, this limit on the duration of the GST exemption would be achieved at the appropriate time by increasing the inclusion ratio of the trust to one, thereby rendering no part of the trust exempt from GST tax.

The proposal would apply on and after the date of enactment to all trusts subject to the generation-skipping transfer tax, regardless of the trust's inclusion ratio on the date of enactment. This proposal is substantially similar to the proposal included in the two prior Green Books.

KPMG observation

This proposal would potentially reduce the transfer tax benefits of creating very long-term or perpetual trusts as such trusts would only be shielded from transfer tax for a more limited period of time than under current law. However, for donors with great-grandchildren (or even young grandchildren) alive, a trust for their benefit could still exist and be exempt from transfer taxes for a significant period of time. In addition, there could be other non-transfer tax benefits to such perpetual trusts—for example, asset protection, income tax savings, or professional asset management.

Modify income, estate, gift, and generation-skipping transfer tax rules for certain trusts

Modify tax rules for grantor trusts

The following three proposals relating to GRATs specifically and grantor trusts more generally are substantially similar to the proposals included in the prior two Green Books.

Grantor retained annuity trusts

A grantor retained annuity trust (GRAT) pays the grantor an annuity each year, and any remaining assets in the trust at the end of the annuity term pass to the remainder beneficiaries (typically, the creator's children). If the grantor retains a sufficiently large annuity payment during the term—equal in value to the assets originally transferred to the GRAT plus the required assumed rate of return— the value of the remainder gift can be "zeroed out," such that no taxable gift is made. If the grantor survives the term and the assets in the trust outperform the assumed rate of return, the excess passes to the beneficiaries free of gift tax. However, if the grantor dies during the term, the assets are included in the grantor's estate for estate tax purposes, and the GRAT's benefit (the tax-free transfer of appreciation on the assets in excess of the annuity payments) is not realized. Taxpayers have become adept at maximizing the benefit of the GRAT by minimizing the term (and reducing the risk that the grantor will die during the term) and by retaining annuity interests significant enough to reduce the gift tax value of the remainder interest to zero.

The proposal would require, in effect, some downside risk in the use of this technique by imposing the requirement that a GRAT have a minimum term of 10 years and a maximum term of the life expectancy of the annuitant plus 10 years. The proposal also would include a requirement that the remainder interest have a value equal to the greater of 25% of the value of the assets transferred to the GRAT or $500,000 and would prohibit any decrease in the annuity during the GRAT term. This would increase the risk that the grantor fails to outlive the GRAT term and the resulting loss of any anticipated transfer tax benefit. The proposal would apply to all GRATs created on or after the date of enactment.

Transfers for consideration between a grantor trust and its grantor-owner

Generally, a trust is treated as a grantor trust if the grantor retains certain powers over or benefits in the trust. A deemed owner of a grantor trust is treated as owning the assets of the trust solely for income tax purposes. As a result, sales and other transactions between a grantor trust and its grantor-owner are disregarded for income tax purposes and generate no capital gain.

The proposal would treat the transfer of an asset for consideration between a grantor trust (other than a revocable trust) and its grantor-owner as one that is regarded for income tax purposes, which would result in the seller recognizing gain on any appreciation in the transferred asset and the buyer owning the asset with a basis equal to the value of the asset at the time of the transfer. Such regarded transfers would include sales as well as the satisfaction of an obligation (such as an annuity or unitrust payment) with appreciated property. The proposal would also add these transactions to those for which losses are disallowed under section 267(b). The gain recognition portion of the proposal would apply to all transactions between a grantor trust and its grantor-owner occurring on or after the date of enactment.

Payment by grantor of income tax on grantor trust's income

The income tax liability attributable to a grantor trust's assets is the obligation of the grantor-owner, rather than the obligation of the trust or its beneficiaries. No amount paid by the deemed owner of a grantor trust to satisfy the trust's income tax liability is treated as a gift by the owner to the trust or its beneficiaries for Federal gift tax purposes.

The proposal would provide that the payment of the income tax on the income of a grantor trust is a gift on December 31 of the year in which the income tax is paid unless the grantor-owner is reimbursed by the trust during the same year. The amount of the gift cannot be reduced by a marital or charitable deduction or by the annual gift tax exclusion. The proposal characterizing the grantor's payment of income taxes as a gift would apply to all trusts created on or after the date of enactment.

KPMG observation

The tax rules regarding what qualifies as a completed transfer for income tax purposes and for estate tax purposes are not identical. Because of these differences, an irrevocable trust can be structured so its assets are excluded from the grantor's estate (and considered completed gifts) but its income is taxed to the grantor (as if the gift had not been made). A trust known as an intentionally defective grantor trust takes advantage of these differences, allowing the trust assets to grow undiminished by income tax (because the tax liability associated with such growth is paid by the grantor of the trust rather than the trust itself) for the benefit of future generations while also removing growth on assets gifted or sold to the trust from your estate for estate tax purposes. As discussed above, a trust that is treated as not separate from the grantor for income tax purposes has another advantage - sales of appreciated assets by the grantor to the trust are ignored for income tax purposes and generate no capital gain. Nor does a sale to the trust result in gift tax liability, as the transfer of additional assets to the trust is for full and adequate consideration. The prior two proposals appear to be directed at substantially reducing the benefits of this estate freeze technique.

KPMG observation

The proposal that would regard sales between a grantor-trust and its grantor-owner would also appear to prevent the grantor from making tax-free purchases of appreciated assets owned by the trust prior to death. This technique is sometimes utilized so that the appreciated assets are owned in the grantor's individual name at death and accorded a step-up in basis. If this proposal were enacted, a tax-free purchase could no longer be achieved.

Adjust a trust's GST inclusion ratio on transactions with other trusts

The GST tax is imposed on generation-skipping transfers from a trust at a rate equal to the product of highest estate tax rate (currently 40%) and the trust's inclusion ratio. A trust's inclusion ratio is the fraction of the trust that is not exempt from GST tax. (For example, if the trust has an inclusion ratio of 0, then the trust is completely exempt.) This ratio must be redetermined at certain times, including each time an additional contribution is made to the trust (whether by a donor or through the consolidation of two trusts) and each time additional GST exemption is allocated to the trust. On the other hand, there is no need to redetermine the inclusion ratio if assets are purchased by a trust for full and adequate consideration as this is just a reinvestment of trust assets rather than an additional contribution.

The proposal would treat a trust's purchase of assets from, or interests in, a trust that is subject to GST tax (regardless of the selling trust's inclusion ratio), as well as a purchase of any other property that is subject to GST tax, as a change in principle which would require the redetermination of the purchasing trust's inclusion ratio. If the selling trust is not completely exempt from GST tax, this could have the effect of diluting the purchasing trust's exempt status. The proposal would apply to all such transactions occurring after the date of enactment. This proposal is substantially similar to the proposal included in last year's Green Book.

KPMG example

Assume a trust has $10M in assets and an inclusion ratio of zero (i.e., the trust is fully exempt from GST tax). The trust then buys $1 million in assets from a non-exempt trust (i.e., a trust with an inclusion ratio of 1) for $1 million in cash. This purchase of non-exempt assets would dilute the trust's exempt status and result in a new inclusion ratio of 10%. As a result, unless additional GST exemption was allocated to the trust, GST tax would be due at the time of any generation-skipping transfers.

KPMG observation

Some taxpayers have taken the position that a GST exempt trust can purchase the remainder interest in a non-exempt zeroed-out GRAT (when the value of the remainder interest after the grantor's retained annuity is worth next to nothing), and then, at the end of the GRAT term, when the GRAT assets are paid over to the exempt trust, there is no change to the exempt trust's inclusion ratio. In essence, according to the Green Book, the purchase by the GST exempt trust "cleanses the purchased interest of its GST potential". It is unclear how the proposal would apply in this scenario. Redetermining the inclusion ratio by adding the de minimis value of the purchased remainder interest would not seem to dilute the exempt status of the purchasing trust in a significant way. Perhaps the proposal would redetermine the inclusion ratio instead by adding the value of the assets owned by the GRAT either at the time of the remainder purchase or at the end of the GRAT annuity term.

Change the GST tax characterization of certain tax-exempt organizations

The GST tax may be imposed on a termination of an interest in a trust (e.g., resulting from the death of a beneficiary) unless a non-skip person (a term which includes a tax-exempt organization) still has an interest in the trust. Although interests held by most charitable tax-exempt organizations are ignored under current law, interests held by other non-charitable tax-exempt organizations are taken into account. As a result, naming one of these non-charitable tax-exempt organizations as a potential recipient of trust distributions is enough to avoid the imposition of GST tax on the trust, even though that organization may be unlikely to ever receive a distribution from the trust.

The proposal would ignore trust interests held by non-charitable tax-exempt organizations – specifically, organizations described in section 501(c)(4) through (29) (other than (10)) (e.g., social welfare organizations, business leagues, social clubs, and veterans' organizations)—such that inclusion of these organizations as permissible beneficiaries of the trust would not prevent the occurrence of a taxable termination. The proposal would apply in all tax years beginning after the date of enactment. This proposal is substantially similar to the proposal included in last year's Green Book.

Modify the definition of a guaranteed annuity from a charitable lead trust (CLAT)

CLATs are often used to minimize transfer tax while benefiting both charity and family members. A charity chosen by the donor must receive annuity payments for a certain number of years and the remaindermen (typically, the donor's children) will receive the corpus at the end of the trust term. If the value of the income interest given to charity is significant enough, the gift to the children will be de minimis (or even "zeroed-out") and any gift tax exemption used or gift tax paid will be minimized. If the trust assets outperform the assumed appreciation rates at the time of the gift, the remaining amount passes to family members free of gift tax. This tax-free gift of excess appreciation can be enhanced further by minimizing payments to the charity during the early years of the CLAT and increasing them over time.

The proposal would require the value of the remainder interest for gift tax purposes at the creation of the CLAT equal at least 10% of the value of the property contributed to the CLAT such that it would no longer be possible to zero-out a CLAT. The proposal would also require level, fixed annuity payments to be paid to the charity during the term of the CLAT. The proposal would apply to all CLATs created after the date of enactment. This proposal is substantially similar to the proposal included in last year's Green Book.

KPMG observation

In addition to preventing taxpayers from creating more traditional zeroed-out CLATs, this proposal would also preclude use of a technique known as a "Shark Fin CLAT". A Shark Fin CLAT provides for a very modest annuity payment for most of the CLAT term with a significant increase in the annuity payment at the end of the term. (It gets its name from the graph of these annuity payments over time.) As mentioned above, this delay in making distributions to charity potentially allows for more growth in the assets and a larger gift tax benefit. If enacted, this proposal would eliminate this technique by requiring a constant annuity amount during the term.

Modify the tax treatment of loans from a trust

Although non-grantor trusts can be subject to income tax as separate taxable entities, they also serve as conduits when they make distributions to beneficiaries; a trust's income is allocated between the trust and its beneficiaries, ensuring that income is only taxed once, under various provisions of the Code. There can also be transfer tax consequences associated with trust distributions (whether from grantor trusts or non-grantor trusts)—for example, distributions from non-exempt trusts to the grandchild of the grantor or other skip person could be subject to GST tax. However, except for certain loans from a foreign trust to a U.S. person, a bona fide loan from a trust does not carry with it any tax consequences to the borrower, although it does result in economic consequences in the form of the obligation to pay interest on the debt as well as to ultimately repay the principal.

The proposal would treat a loan made by a trust to a beneficiary as a distribution for income tax purposes, carrying out an appropriate portion of taxable income to the borrower. Additionally, the loan would be treated as a distribution for GST tax purposes, potentially subject to GST tax if the loan is to a skip person beneficiary (and presumably only if the trust is not otherwise exempt from GST). If the loan is repaid, a refund of the GST tax paid, with interest (only from the date of the claim for refund), could be refunded to the party that incurred the GST tax liability initially (e.g., the beneficiary in the case of a taxable distribution).

With respect to loans to the grantor-owner of a grantor trust (or the spouse of the grantor-owner), the repayment of any loan to the trust would be treated as a new contribution by the borrowing deemed owner for GST tax purposes. As with any contribution to a trust, there could be GST tax consequences at that time depending on the terms of the trust—GST tax liability in the case of a direct skip, an opportunity to allocate GST exemption, or an increase in the trust's inclusion ratio if exemption is not allocated.

The proposal allows for regulations to be drafted that would identify certain loan types that would not be subject to this proposal. It is indicated that, for example, this authority could be used to exempt short term loans or short-term permission to use real or tangible property owned by the trust.

The proposal would apply to loans made, as well as to existing loans renegotiated or renewed by trusts after the year of enactment. This proposal is substantially similar to the proposal included in last year's Green Book.

KPMG observation

The reference to a regulatory exception for short-term permission to use real or tangible property may indicate that the proposal itself is intended to apply not only to actual loans but also to allowing a beneficiary to use trust property. This would be similar to the current rules applicable to interactions between a foreign trust and a U.S. person beneficiary.

KPMG observation

It is not entirely clear whether the proposal regarding borrowing by a deemed owner under the grantor trust rules would apply to borrowing by a beneficiary who is treated as the owner of the trust in accordance with section 678 of the Code or whether it would be limited to grantor-owners. If beneficiary-owners are included, payback of the loan by that person would then cause the trust to have more than one transferor for GST tax purposes and require the calculation of a separate inclusion ratio for that transferor. Beneficiary generation assignments would then need to be tracked with respect to the additional deemed transferor.

KPMG observation

Since the payback of a loan by the grantor-owner of a grantor trust would be treated as an additional contribution by the grantor if this proposal were enacted, care should be taken to generally not have the grantor borrow funds from a GST grandfathered trust (because the additional contribution might be treated as voiding the grandfathered status) or from a trust that otherwise has a zero-inclusion ratio unless the grantor has enough remaining GST exemption to cover the additional contribution.

Revise rules for valuation of certain property

Require consistent valuation of promissory notes

Generally, an individual who lends money at a below-market rate of interest to another individual is treated as making a gift for gift tax purposes and the lender is imputed a commensurate amount of income for Federal income tax purposes. To avoid those consequences, the interest rate must be at least equal to the minimum monthly rate (based on the duration of the loan) issued by the IRS. Sometimes a taxpayer will enter into a loan that bears this “safe harbor” interest rate, taking the position that the loan is not below market for gift tax purposes, but subsequently discounts the value of the unpaid note for gift or estate tax purposes because the interest rate is below the current market rate or because of other underlying economic characteristics (such as a very lengthy term).

The proposal would impose a consistency requirement by providing that, if a taxpayer treats any promissory note as having a sufficient rate of interest to avoid the treatment of any foregone interest on the loan as income or any part of the transaction as a gift, that note subsequently must be valued for Federal gift and estate tax purposes by limiting the discount rate to the greater of the actual rate of interest of the note, or the applicable minimum interest rate for the remaining term of the note on the date of death. The Secretary would be granted regulatory authority to establish exceptions to account for any difference between the applicable minimum interest rate at the issuance of the note and the actual interest rate of the note. In addition, if there is a reasonable likelihood that the note will be satisfied sooner than the specified maturity date, the Secretary could treat the note as being short term regardless of the due date, value term loans as demand loans in which the lender can require immediate payment, or reduce the stated term to earliest possible date on which the related property could be monetized.

The proposal would apply to valuations as of a valuation date on or after the date of enactment. This proposal is substantially similar to the proposal included in last year’s Green Book.

Revise the valuation of partial/fractional interests in certain assets transferred intrafamily

The gift and estate taxes both apply to the fair market value (FMV) of the transferred property. FMV for gift or estate tax purposes is the price at which the property would change hands between a willing buyer and a willing seller. A buyer would pay less, and a seller would accept less for a minority interest in a closely held enterprise than they would for a proportionate share of the underlying assets because of the interest's inherent limitations on access to the economic benefits. These limitations are reflected through the application of discounts on the underlying asset value for: (1) lack of control – applicable to a minority interest in a business because the owner of such an interest cannot unilaterally make management decisions or control distributions; and (2) lack of marketability—applicable to an interest in a closely held business because the owner of such an interest cannot easily liquidate or transfer his interest due to the limited market or universe of buyers and restrictions on transferability.

When taxpayers make intrafamily transfers of interests in such entities (instead of transferring the underlying assets themselves), they often claim entity-level discounts in valuing the gift, leveraging their lifetime exemption and minimizing transfer tax exposure. Section 2704(b) of the Code disregards the effects on FMV of liquidation restrictions on controlled partnerships and corporations in limited circumstances but does not modify the FMV of partial interests in assets.

The proposal would replace section 2704(b) of the Code and provide that the FMV of a partial interest in non-publicly traded property (real or personal, tangible or intangible) transferred to or for the benefit of a family member of the transferor would be the interest's pro rata share of the collective FMV of all interests in that property held by the transferor and the transferor's family members (directly, through a general partnership or wholly owned entity, or in a trust for the person's sole benefit or that is revocable). Family members for this purpose would include the transferor, the transferor's ancestors and descendants, and their spouses. This rule would not apply to the portion of the interest attributable to assets actively used in the conduct of a trade or business; rather it would apply to the portion of the interest attributable to passive assets. In addition, the special valuation rule would only apply if the family collectively (after attributing the maximum interest held through an entity or trust to a member) had an interest of at least 25% of the whole.

The proposal would apply to valuations as of a valuation date on or after the date of enactment. This proposal is substantially similar to the proposal included in last year's Green Book.

KPMG observation

The IRS has historically taken the position that valuation discounts should not apply in certain circumstances—for example, gifts of family limited partnership interests when the partnership holds marketable securities or other liquid assets and the partnership is owned and controlled by family members. Consistent with this position, the IRS and Treasury proposed regulations under section 2704 in 2016. These regulations were criticized as being too broad, as overthrowing the willing buyer-willing seller standard of "fair market value," as exceeding Treasury's statutory authority, and as destroying family-owned businesses. Ultimately, they were withdrawn in 2017 in response to President Trump's executive order that agencies identify recent regulations that imposed an undue financial burden on taxpayers or added undue complexity to the tax laws or exceeded the agency's statutory authority. This proposal may be intended to acquire the requisite statutory authority to support the IRS's attack on entity-level (or partial interest) discounts in the intrafamily context.

Close loopholes

Tax carried (profits) interests as ordinary income

The administration's budget proposals include a measure to tax carried interests in investment partnerships as ordinary income subject to self-employment taxes for partners whose taxable income (from all sources) exceeds $400,000. The proposal appears to be substantially similar to proposals that were included in several of the Obama Administration's budget proposals. The proposal would repeal current section 1061 for all taxpayers whose taxable income exceeds $400,000. While not explicit, this phrasing suggests that current section 1061 would continue to apply to taxpayers whose income does not exceed $400,000.

The Green Book generally indicates that the administration's proposal would tax as ordinary income a partner's share of income from an investment services partnership interest (ISPI) in an investment partnership; would require the partner to pay self-employment taxes on such income; and generally, would treat gain recognized on the sale of such interest as ordinary. An ISPI generally would be an interest in an investment partnership that is held by a person who provides services to the partnership. A partnership would be an investment partnership only if: (1) substantially all of its assets were investment-type assets (certain securities, real estate, interests in partnerships, commodities, cash or cash equivalents, or derivative contracts with respect to such assets); and (2) over half of the partnership's contributed capital was from partners in whose hands the interests constitute property not held in connection with a trade or business. As with similar past proposals, the administration's proposal provides exceptions for "invested capital," as well as anti-abuse rules applicable to certain "disqualified interests."

As was also the case for similar prior proposals, the Green Book indicates that:

> …to ensure more consistent treatment with the sales of other types of businesses, the [a]dministration remains committed to working with Congress to develop mechanisms to assure the proper amount of income recharacterization where the business has goodwill or other assets unrelated to the services of the ISPI holder.

This language apparently signals an intention to provide relief from income recharacterization for gain attributable to "enterprise value" associated with a sponsor's business as opposed to its share of carried interest.

Although light on details, the structure of the Green Book proposal is similar to that of the proposed Carried Interest Fairness Act of 2021 (H.R. 1068). The rules described in that bill are extremely complex (statute is 44 pages), and the rules provide for results that extend well beyond character conversion—e.g., override nonrecognition on many ISPI disposition transactions and distributions of property with respect to an ISPI, treat income allocated with respect to an ISPI as non-qualifying income for publicly-traded partnerships starting 10 years after the effective date, etc.

The proposal would be effective for tax years beginning after December 31, 2024.

Repeal deferral of gain from like-kind exchanges

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

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

The proposal would be effective for exchanges completed in tax years beginning after December 31, 2024.

Treasury estimates that the proposal would raise $19.678 billion over 10 years.

KPMG observation

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

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

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

States generally adopt federal income as the starting point for computation of the state income tax base. If a state automatically conforms to the Code and this federal change is made, the state would correspondingly recognize gain from exchanges. Similarly, if the proposed federal rule is enacted, and a state with static conformity updates its rules to follow the federal rule change, then a taxpayer in this state would also recognize gain from exchanges. If a state with static conformity does not update its conformity to the Code, then gain from an exchange may continue to be deferred in that state. The determination of the overall impact on the exchanging parties may vary by state if the properties involved in the exchange are in multiple states because certain of these states may follow the proposed federal recognition rules, while other states may continue to permit the deferral.

The administration proposes to have this change effective for exchanges **completed** in tax years beginning after December 31, 2024. By focusing on the date on which an exchange is completed, the administration's proposal could apply to exchanges that begin prior to January 1, 2024. In particular, the proposal could impact any like-kind exchange that begins on or after July 5, 2024, if the taxpayer relies on the entire 180-day exchange period for completing the exchange.

Require 100% recapture of depreciation deductions as ordinary income for certain depreciable real property

The administration's proposal would require gain on the disposition of section 1250 property held for more than one year to be treated as ordinary income to the extent of depreciation deductions taken in tax years beginning after 2024, effective for dispositions completed in tax years beginning after 2024. Section 1250 property includes tangible and intangible real property that is not otherwise defined as section 1245 property.

Under current law, gain on the disposition of section 1250 property held for more than one year is only required to be treated as ordinary income to the extent that depreciation claimed on the asset exceeds depreciation that would have been claimed had depreciation been computed using a straight-line method. However, if the section 1250 property is held for one year or less, all depreciation is recaptured as ordinary income, regardless of whether it exceeds straight-line depreciation.

The proposal would not apply to individual taxpayers with adjusted gross income (AGI) lower than $400,000, or $200,000 for married individuals filing separately, determined without regard to the proposal. Flow-through entities would be required to compute and report gains and losses on section 1250 property under both the old and new law. Any gain on disposition of section 1250 property in excess of recaptured depreciation would be treated as section 1231 gain. The 25%-rate for unrecaptured section 1250 gain for individuals remains unchanged, although the amount of unrecaptured section 1250 gain would generally decrease under the proposal.

The proposal is estimated to raise approximately $7.3 billion over the 10-year budget window (i.e., 2025–2034).

KPMG observation

A substantively identical proposal was included in both the FY 2023 and FY 2024 Green Books. The proposal would result in identical treatments of disposition gains under sections 1245 and 1250 for most taxpayers, and should likely be viewed alongside the administration's proposals to increase the top marginal income tax rate for high-income earners and reform the taxation of capital income, described above.

Modify depreciation rules for purchases for general aviation passenger aircraft

The administration's proposal would increase the depreciable recovery period for "general aviation passenger aircraft" to seven years under the modified accelerated cost recovery system (MACRS) and to twelve years under the alternative depreciation system (ADS). The proposal defines the term "general aviation passenger aircraft" as including any airplane (including airframes and engines) not used in the commercial or contract carrying of passengers or freight, but which primarily engages in the carrying of passengers (other than in connection with emergency or emergency relief operations). Such term excludes airplanes primarily engaged in non-passenger activities (e.g., crop dusting, firefighting, aerial surveying, etc.).

Under current law, general aviation passenger aircraft (as defined under the proposal and commonly referred to as "corporate jets") are generally depreciable over a five-year MACRS recovery period and six-year ADS recovery period.[2] Alternatively, commercial passenger aircraft (except helicopters) are generally depreciable over a seven-year MACRS recovery period and 12-year ADS recovery period.[3]

The proposal is effective for property placed in service after December 31, 2024, and is estimated to raise approximately $1.5 billion over the 10-year budget window (i.e., 2025–2034).

KPMG observation

A substantively identical proposal has been included in numerous previous Green Books. The proposal would result in the identical treatment of corporate jets and commercial passenger aircraft for depreciation purposes.

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[2] See Asset Class 00.21 of Rev. Proc. 87-56, 1987-2 C.B. 674, "Airplanes (airframes and engines), except those used in commercial or contract carrying of passengers or freight, and all helicopters (airframes and engines)." Note that while helicopters are included in this asset class, they are not included in the proposal (i.e., under the proposal, helicopters remain depreciable over five years under MACRS and over six years under ADS).
[3] See Asset Class 45.0 of Rev. Proc. 87-56, *supra*, "Air Transport" (i.e., assets (except helicopters) used in commercial and contract carrying of passengers and freight by air.)

Limit use of donor advised funds to avoid a private foundation payout requirement

The proposal provides that a private foundation's distribution to a donor advised fund (DAF) would not be a qualifying distribution unless:

- The DAF distributes the funds by the end of the following tax year as a qualifying distribution, which would not include a distribution to another DAF

- The private foundation maintains records or other evidence confirming that the DAF distributed the funds as qualifying distributions within the required time

Currently, private non-operating foundations must distribute 5% of their non-charitable use assets annually (the "5% payout"). However, they cannot count amounts distributed to a controlled entity or another private non-operating foundation toward that 5% payout unless the funds are in turn distributed by the recipient "out of corpus" by the end of the following tax year as qualifying distributions.

The proposal states that it would be effective after the date of enactment.

KPMG observation

This proposal is similar to a proposal introduced in Congress in 2021 and 2022, which would have effectively treated distributions by private non-operating foundations to DAFs the same as distributions to controlled entities and other private non-operating foundations for purposes of the 5% payout. If enacted, a grant from a private non-operating foundation to a DAF would only count as a qualifying distribution if the DAF re-distributed the funds "out of corpus" as a qualifying distribution by the end of the following tax year. "Out of corpus" is a term of art referring to qualifying distributions in excess of the qualifying distributions required under the 5% payout (or, in the case of a recipient that is a public charity, that would be required if a 5% payout applied to the public charity). In applying this "out of corpus" concept to a DAF, the prior congressional proposals have been unclear regarding whether a notional 5% payout would be determined at the level of the DAF or the level of the charity that maintains the DAF (commonly referred to as the "sponsoring organization").

Exclude payments to disqualified persons from counting toward private foundation payout requirement

The proposal provides that a private foundation's payment of compensation or reimbursements of expenses to certain "disqualified persons" (namely, substantial contributors, their family members, and certain entities owned by them) would not be a qualifying distribution that would count toward the foundation's 5% payout.

The proposal would be effective for payments made and expenses reimbursed after the date of enactment.

KPMG observation

This proposal is similar to one introduced in prior congressional proposals in 2021 and 2022. That proposal applied only to "administrative expenses," rather than all payments of compensation and reimbursements of expenses.

Extend the period of assessment of tax for certain Qualified Opportunity Fund (QOF) investors

Section 6501 generally requires that the IRS assess a tax within three years after the filing of a tax return. If a taxpayer invests an amount of eligible gain in a Qualified Opportunity Fund (QOF) and elects deferral, that amount of eligible gain is excluded from the taxpayer's income for the year that the gain is realized. A taxpayer who deferred gain under section 1400Z-2 by investing in a QOF will generally recognize the deferred gain upon the earlier of (1) the occurrence of an inclusion event or (2) December 31, 2026. An inclusion event, in general, is any reduction of a taxpayer's equity interest in the QOF, including the sale of interests in the fund and certain distributions by the fund to the taxpayer. Recognition of the gain deferred under section 1400Z-2 may not occur until many years after the filing of the return for the year in which the gain was realized.

The administration's proposal would provide the IRS with an extension of time to assess any deficiency resulting directly or indirectly from a taxpayer's failure to include, or properly reflect the inclusion of, gain deferred in a QOF following the occurrence of an inclusion event. Under the proposal, the time during which the IRS could assess a deficiency resulting directly or indirectly from such failure would not expire before the date that is three years after the date on which IRS is furnished with all the information needed to assess the deficiency.

The proposal would generally be effective for inclusions of deferred gains associated with any QOF investment made after December 22, 2017 (the date of enactment of the TCJA). The proposal, however, would not apply in situations when the statute of limitations has expired prior to the date of enactment of the proposal.

Treasury estimates that the proposal would raise $98 million over 10 years.

KPMG observation

The reporting requirements for QOF investors, if complied with, ought to provide the IRS with sufficient information to identify when an inclusion event has occurred with respect to a particular investor. For example, an investor with an inclusion event must (1) file a Form 8949, *Sales or Other Dispositions of Capital Assets* reporting the gain triggered by the inclusion event, and (2) reflect the inclusion event on Form 8997, *Initial and Annual Statement of QOF Investments*. In addition, if the investor disposes of an interest in the QOF, the fund would report the disposition to the IRS on Form 8996, *Qualified Opportunity Fund* and Form 1099-B, *Proceeds from Broker and Barter Exchange Transactions*.

Despite the various reporting requirements, the administration's proposal reflects a concern that the occurrence of an inclusion event may not be "readily identifiable" on taxpayers' returns. However, if a taxpayer was not aware that an inclusion event occurred (for example, because the taxpayer is invested through a chain of partnerships and is not aware of the inclusion event at a lower-tier partnership) or if the taxpayer simply failed to properly report the inclusion, the IRS would be unaware that the taxpayer should have included the deferred gains. If enacted, the administration's proposal would prevent the IRS from being barred from assessing a deficiency under the general statute of limitations in that circumstance.

The wording of the proposal is quite broad. If enacted as described, the extended statute of limitations would apply not only when the taxpayer failed to include the deferred gain but also if the taxpayer "in any way fails to properly reflect on one or more tax returns" the required inclusion. It is unclear whether this broad language would allow the IRS to keep the statute of limitations open for minor mistakes in reporting the gain, despite the gain having been properly included in income.

Impose ownership diversification requirement for small insurance company election

Section 831(b) allows certain small non-life insurance companies to elect to be taxed only on their taxable investment income less deductions related to such income. The election is available to non-life insurance companies that receive during the tax year net written premiums (or, if greater, direct written premiums) that do not exceed the threshold amount for that year, which is indexed annually for inflation. For this test, the electing company is treated as receiving the (net or direct) written premiums received by all other companies that are members of the same controlled group as the company for which the determination is being made. For this purpose, and for meeting the first diversification requirement (described below), a parent-subsidiary controlled group is defined by using a more-than-50% ownership threshold.

An insurance company must currently meet at least one of two ownership diversification requirements to qualify for an election. A company meets the first diversification requirement if no more than 20% of its net written premiums (or, if greater, direct written premiums) is attributable to any one policyholder. If the first diversification requirement is not met, the second requires that no person holding, directly or indirectly, an interest in the electing insurance company and who is a spouse or lineal descendent of an individual holding an interest in a business or in other assets being insured by the insurance company has a greater percentage interest in the insurance company than he or she has in the business or assets being insured.

Under the proposal, to qualify for the alternative tax regime, an insurance company would be required to meet the following conditions: 1) Qualify as a non-life insurance company; 2) Have net written premiums (or, if greater, direct written premiums) for the tax year that do not exceed a statutorily determined amount ($2.8 million in 2024); and 3) Have no more than 20% of the assets or the voting power or value of the stock of such company owned, attributed, or constructively owned by: (a) a policyholder of such company or an owner of such policyholder, or (b) collectively by a policyholder or owner of a policy holder and one or more persons related to that policyholder or owner. The Secretary would also be authorized to issue guidance regarding possible requirements for new elections, revocation of prior elections, and related tax consequences for companies that previously qualified for the election but do not qualify under the new standard. The two ownership diversification requirements under current law would be repealed.

The proposal would be effective for tax years beginning after December 31, 2024.

KPMG observation

There has been much litigation surrounding section 831(b) and its application to companies that may or may not qualify as insurance companies for federal income tax purposes. In addition, proposed regulations were issued in April 2023 that would make certain micro-captive transactions either transactions of interest or listed transactions. For purposes of the proposed regulations, an entity subject to the new rules would include any entity that (1) elects under IRC section 831(b) to exclude premiums from taxable income, (2) issues a contract to an Insured and/or reinsures an Intermediary's contract for an Insured; and (3) has at least 20% of its assets, or the voting power or value of its outstanding stock or equity interests, directly or indirectly owned, individually or collectively, by an Insured, owner, or related persons. The proposal above takes a somewhat similar approach with respect to the ownership and control requirements set forth in the proposed regulations.

Expand pro rata interest expense disallowance for business-owned life insurance

Interest paid or accrued on policy loans or other indebtedness with respect to life insurance, endowment, or annuity contracts generally is not deductible unless the contract insures the life of a current key person of the business and the amount of the indebtedness does not exceed $50,000 per key person insured. The amount of such deductible interest is limited to an amount determined using an average corporate bond yield. A key person is an officer or 20% owner of the business, but the number of key persons is capped at between five and 20 individuals, depending on the size of the business. This interest-disallowance rule applies only to the extent that the relevant indebtedness can be traced to a non-excepted life insurance, endowment, or annuity contract.

Pursuant to section 264(f), the interest deductions of a business other than an insurance company are also reduced to the extent the general interest expense of the business is allocable to unborrowed policy cash values of life insurance, endowment, or annuity contracts. This allocation is based on the ratio of the company's average unborrowed policy cash values to average total assets. An exception to the pro rata interest-disallowance rule applies with respect to contracts that cover individuals who were officers, directors, employees, or 20% owners of the trade or business at the time the individual was first covered by the contract. There is no limit to the number of such excepted individuals. The unborrowed cash values of excepted contracts are not taken into account in either the numerator or the denominator of the interest allocation formula.

The proposal would repeal the section 264(f)(4)(A)(ii) exception from the overall section 264(f) pro rata interest expense disallowance rule for life insurance, annuity, and endowment contracts covering employees, officers, or directors of a business that is the owner or beneficiary of the contracts. The proposal would leave intact section 264(f)(4)(A)(i) exception for contracts covering 20% owners of the business that owns the contract.

The proposal would apply to contracts issued after December 31, 2024. For this purpose, any material increase in the death benefit or other material change in the contract would cause the contract to be treated as a new contract, except in the case of a master contract, for which the addition of covered lives would be treated as a new contract only with respect to the additional covered lives.

Modify rules for insurance products that fail the statutory definition of a life insurance contract

Rules governing failed life insurance contracts would be modified in several respects to ensure that all policyholder earnings are taxed, and not included in tax-exempt death benefits. The proposal identifies a specific type of foreign-issued life insurance contract, a "frozen cash value (FCV)" contract, that does not allow access to the policy's value via withdrawals of cash value, loans, or surrenders. The net surrender value of an FCV contract will never exceed the premiums paid for the contract, and in many cases the net surrender value will be less than the premiums paid. Generally, US states have non-forfeiture laws that prohibit the sale of such contracts by US-based life insurance companies. The proposed change to section 7702(g) would fully tax to the policyholder the earnings accruing on a failed contract's underlying investments, as well as the mortality charges. The goal would be accomplished through three proposed changes.

First, the current law definition of income for a failed contract would be modified by substituting "net investment value" for net surrender value. A failed contract's net investment value would be defined as the amount representing the contract's death benefit, less the contract's amount at risk and any specific charges that might be imposed upon a contract's surrender. This change would mean that the policyholder of any failed contract (including FCV contracts) would be subjected to current taxation on the earnings credited to that contract.

Second, amounts distributed and policy loans from a failed contract would be deemed to be amounts distributed or loaned under a modified endowment contract. For this purpose, the definition of investment in the contract would be amended to include income on the contract that has been taxed prior to the distribution or loan date, other than amounts equal to the cost of life insurance protection.

Third, the excess of the amount paid by the reason of the death of the insured over the net investment value of the contract would be treated as death benefits when calculating taxable income.

The proposal would be effective for tax years beginning after December 31, 2024 for life insurance contracts issued under applicable law on or after the day following the date of publication of this Green Book. Thus, all earnings and gains credited to failed contracts owned by U.S. persons that were issued after this publication date would be included in the U.S. policyholder's "income on the contract" for tax years beginning after December 31, 2024. For any qualifying life insurance contracts issued after the publication date that become failed contracts in later years, any prior amounts of untaxed investment value would become taxable in the year of contract failure. Any substantial modification of an existing life insurance or annuity contract, or exchange of one such contract for another, would be treated as the issuance of a new contract for this purpose. Future withdrawals of cash value from a newly failed contract and any associated policy loan would be deemed funded from the policy's investment in the contract and would not be treated as a taxable distribution.

KPMG observation

In general, investment earnings credited to qualified life insurance policies are not taxable until deemed distributed. Cash distributions from a life insurance contract are generally treated as coming first from the investment in the contract (equal to aggregate premiums paid, less aggregate untaxed distributions), thus not taxable until all the investment has been withdrawn.

If a life insurance contract fails to comply with the requirements of section 7702(a), the tax deferral accorded to life insurance contracts will be lost. Instead, under section 7702(g), "income on the contract" will accrue each year from the date of failure. Income on the contract for this purpose is defined as the excess of the sum of the increase in the net surrender value during the tax year and the cost of life insurance protection for such year, over the premiums paid during such year. Also, in the year of failure, the income on the contract accruing in all prior contract years is treated as received or accrued by the taxpayer. The contract's net amount at risk, calculated for this purpose as the difference between the death benefit and the net surrender value, continues to be excludible from income under section 101 to the same extent as death benefits under complying contracts.

Policy loans received during the life of the insured are generally considered to be nontaxable to the extent that they are limited to premiums paid and therefore deemed to be a return of the contract's basis.

For tax purposes, FCV contracts are designed to be life insurance contracts under the applicable foreign law but failed life insurance contracts under the U.S. Tax Code. A U.S. taxpayer who is a policyholder of such an FCV contract is subject to tax on the policy's income on the contract, which will typically be zero or very low according to the IRS because the net surrender value of an FCV contract is attributable only to premium payments and the cost of insurance protection also is relatively small and could be zero. In addition, increases in a FCV contract's asset value are not included in taxable income because they are either offset by a payment of premiums during the tax year or are not part of a contract's net surrender value. Furthermore, both partial withdrawals and policy loans received during the life of the insured are generally considered to be nontaxable because they are limited to premiums paid and therefore deemed to be a return of the contract's basis.

FCV-type contracts allow US taxpayers to avoid paying tax on income that would otherwise be taxable. This provides an advantage to foreign life insurance companies over U.S.-based life insurers because U.S.-based life insurance companies are prohibited from selling these products. These proposed changes, however, do not keep U.S. taxpayers from buying life insurance from foreign life insurance companies when such foreign-issued policies meet the U.S. taxpayer's needs.

Limit tax benefits for private placement life insurance and similar contracts

Some insurance companies offer customized "private placement" life insurance (PPLI) and annuity (PPA) contracts to wealthy individuals or as business-owned life insurance. Companies selling PPLI contracts generally require annual premiums on such policies of at least $1 million for several years. PPLI and PPA contracts are taxed just as other life insurance and annuity products are taxed. In general, investment earnings credited to the cash value of a life insurance or annuity contract are taxable only if the income on the contract is deemed distributed to the policyholder. Thus, such earnings enjoy a deferral of tax liability not available if the invested assets supporting the insurance or annuity contract were held outside of the contract.

The proposal would limit the tax benefits for PPLI and PPA contracts. It would do so by defining a class of contracts ("Covered Contracts") that are predominantly investment oriented and denying these contracts most of the tax benefits that are generally granted to life insurance and annuity contracts. Covered Contracts would also be subject to additional reporting requirements.

Covered Contracts would be subject to the following tax consequences:

1) Any funds distributed to a policyholder or contract beneficiary from a Covered Contract prior to the contract's annuity starting date (if applicable) would be taxed as ordinary income to the extent the contract's investment value exceeds its investment in the contract (income-first rule). In addition to partial or full surrenders of cash value, distributions would include amounts payable as death benefits, received as policy loans, and cash value assigned or pledged to any person. A life insurance contract's investment value would be defined on a given date as the greater of (a) the contract's cash value and (b) an amount equal to the contract's death benefit, less the contract's amount at risk (i.e., the amount of pure insurance protection). An annuity contract's investment value would equal its cash value.

2) Amounts paid after the annuity starting date (if applicable) would be treated as under current law.

3) Amounts paid from a life insurance contract by reason of the insured's death would be taxable as ordinary income, but only to the extent the beneficiary's share of the contract's investment value exceeds the beneficiary's share of the contract's investment in the contract. A contract's investment value and investment in the contract would be allocated to multiple beneficiaries in proportion to the allocation of the death benefit itself to those beneficiaries.

4) An additional tax equal to 10% of any taxable distribution from a Covered Contract would be assessed. The current Code exceptions to the 10% penalty tax that apply to taxable amounts received from a MEC or an annuity would not apply to Covered Contracts.

5) A Covered Contract's investment in the contract, as well as its basis for determining taxable gain or loss, would be determined as under current law but would be reduced by any mortality charges that have been assessed against the contract's investment value.

For this purpose, Covered Contracts include the following variable contracts:

1) Any PPLI or PPA contract, defined as a variable contract subject to SEC regulation as a security that is not a registered product with the SEC, with respect to which the purchaser, as a condition of purchase, must have sufficient income and wealth to qualify (or can otherwise qualify) as an accredited investor or qualified purchaser under SEC regulations at the time of purchase.

2) Any variable life insurance contract any of whose premiums are paid, directly or indirectly, in kind rather than in cash.

3) Any variable life insurance contract whose underlying assets include assets purchased, directly or indirectly, from the policyholder, persons related to the policyholder, or a business or other entity in which the policyholder or a related person has more than a de minimis ownership interest.

4) Any variable life insurance contract that, in combination with contracts owned by persons related (directly or indirectly) to the contract's policyholder, owns an interest in a separate account of an insurance company, and the cash value of the related contracts, in the aggregate, represents at least 5% of the value of any distinct investment option whose assets are accounted for in that separate account.

5) A variable life insurance contract issued outside of the United States, if any of the investment assets supporting the contract, if supporting a contract sold or marketed in the United States, would cause that contract to be salable only to an accredited investor or qualified purchaser and subject to SEC regulation as a security.

Covered Contracts would not include contracts held by nonnatural persons that are already subject to annual taxation of earnings as well as contracts issued under certain qualified retirement plans.

The Secretary would be authorized to issue regulations to prevent avoidance of variable contract status, and to prevent avoidance of Covered Contract status by conduit arrangements or otherwise. In addition, the Secretary would be authorized to require reporting by insurance companies and policyholders. Insurance companies and policyholders would be subject to appropriate penalties for noncompliance with these reporting requirements. In addition, if a payment recipient omits a taxable amount attributable to a distribution from a Covered Contract from the recipient's reported gross income on an income tax return, the associated income and penalty taxes would be assessable at any time within six years after the return was filed.

The proposal would be effective for tax years beginning after December 31, 2024, for Covered Contracts issued under applicable law on or after the day following the date of publication of the Green Book. Any substantial modification of an existing life insurance or annuity contract, or exchange of one such contract for another, would be treated as the issuance of a new contract for this purpose.

Correct drafting errors in the taxation of insurance companies under the Tax Cuts and Jobs Act of 2017

The Tax Cuts and Jobs Act of 2017 (TCJA) contains two drafting errors related to the taxation of insurance companies. These errors relate to the rates used as capitalization percentages for policy acquisition expenses as well as the inclusion of certain reinsurance lines of business in the "long-tail" lines of business for purposes of the unpaid loss discounting rules.

Policy acquisition expenses

Insurance companies must capitalize, as policy acquisition expenses, a portion of their general deductions otherwise allowed. Capitalized policy acquisition expenses generally equal a percentage of an insurer's net premiums on specified contracts. Prior to TCJA, these percentages equaled 1.75% of net premiums received on annuity contracts, 2.05% of net premiums received on group life insurance contracts, and 7.70% of net premiums received on other life insurance or noncancellable accident and health insurance contracts. In the TCJA, Congress attempted to increase the capitalization percentages to 2.09% for annuity contracts, 2.45% for group life insurance contracts, and 9.20% for other specified contracts, effective for tax years beginning in 2018. These changes represent approximately a 19.5% increase in capitalized amounts for each of the three contract categories. A statutory drafting error, however, misidentified the appropriate language in the Code, so that only the percentage for annuity contracts could be implemented. This proposal would change the capitalization rate of net premiums for group life insurance contracts from 2.05% to 2.45% and the capitalization rate for other non-annuity specified life and health contracts from 7.70% to 9.20%. This proposal would be effective as if it had been a part of the original TCJA and would be treated as a change of accounting method initiated by the taxpayer with the consent of the IRS for the tax year beginning in 2025.

Discounting of unpaid losses

Insurance companies must discount their unpaid loss reserves on property and liability insurance contracts to reflect the fact that unpaid claims and other incurred losses may not be paid for several years into the future. Certain "short-tail" lines of business, such as auto physical damage and warranty insurance, have relatively short payout profiles. Under the tax law, these lines are treated as paying out virtually all their claims by the end of the third year after the accident year. Other lines of business, such as workers' compensation and liability insurance lines, are assumed to pay out claims over much longer periods. Consequently, the average discounting of the unpaid losses under these "long-tail" lines of business is much deeper than the discounts applied to the unpaid losses of "short-tail" lines. Nonproportional reinsurance and international lines of business are deemed to be long-tail lines under the accounting rules promulgated by the National Association of Insurance Commissioners and, prior to enactment of the TCJA, were treated as long-tail lines for purposes of the unpaid loss discounting tax rules. The TCJA significantly modified the discounting rules. However, in enacting these changes, Congress deleted statutory provisions that had addressed the treatment of the nonproportional reinsurance and international lines of business. Under the revised statute, these lines of business would be treated as short-tail lines of business.

This proposal would include the international and nonproportional reinsurance lines of business in the list of "long-tail" lines of business that are explicitly identified in the statute. This list currently includes various liability lines of business, medical malpractice insurance, workers' compensation insurance, and multiple peril lines. This proposal would be effective for tax years beginning after December 31, 2024, for losses incurred and salvage recoverable in accident years beginning after 2024. New loss payment patterns for the international and nonproportional reinsurance lines of business would be determined as if they were promulgated for the 2022 determination year.

Define the term "ultimate purchaser" for purposes of diesel fuel exportation

In general, an excise tax is imposed by section 4081 on taxable fuel, including diesel fuel and kerosene. If diesel fuel or kerosene upon which the tax was imposed is exported, the Internal Revenue Code deems the exportation to be a non-taxable use of the fuel and a credit or refund of tax is allowed to the "ultimate purchaser" of such fuel. Current regulations require certain conditions to allowance for the claim to be allowed, including that tax was imposed on the fuel, the fuel was exported from the United States, the claim was timely filed, and the claim included specific information. However, the Internal Revenue Code does not define the term "ultimate purchaser." Thus, under current law, it is possible for more than one person to qualify as the ultimate purchaser, resulting in the IRS paying a refund of tax twice with respect to the same volume of exported diesel fuel or kerosene.

The proposal would define the person entitled to the refund as the last purchaser in the United States for purposes of diesel fuel and kerosene exportation.

The proposal would be effective for diesel fuel and kerosene exported after December 31, 2024.

KPMG observation

The proposal would address a situation in which it is possible for more than one person to claim a refund of tax with respect to the same quantity of fuel as a result of the exportation of such fuel under current law.

Limit the deduction for the transfer of property to the value of property actually included in income

Currently, an employer's deductions for the transfer of property, such as the employer's own company stock, in connection with the performance of services to the "amount included" in the person's gross income. Uncertainty exists whether an employer is entitled to deduct the amount that is legally required to be included in the service provider's income, or only the amount that the service provider includes in income.

The administration's proposal would amend section 83(h) to limit the service recipient's deduction to the amount actually included in income by the service provider, and to deem the amount reported on the Form W-2 to be included in income for this purpose. The proposal would be effective after December 31, 2024.

Reform excise taxes on business aviation

Under current law, an excise tax is imposed on kerosene jet fuel used in private and corporate jets (noncommercial business aviation) at a rate of 21.8 cents per gallon. The tax is dedicated to the Airport and Airway Trust Fund (AATF) to support Federal Aviation Administration (FAA) activity. Certain uses of kerosene in noncommercial business aviation are exempt from the tax on jet fuel, including use in certain military activity, foreign trade, and farming, or for the exclusive use of a nonprofit educational organization or State or local government.

Noncommercial business aviation accounts for approximately 3% of the FAA's costs but contributes less than 1% to AATF revenue. The proposal would raise taxes on kerosene used for private jet travel, including corporate jets, from the current 21.8 cents per gallon to $1.06 per gallon. The increase would be phased in over a five-year period, from 38.64 cents per gallon in the first year and then increased by 16.84 cents per gallon in each subsequent year until 2029. This proposed excise tax increase would not affect the existing exemptions listed above.

The proposal would be effective for tax years beginning after December 31, 2024.

KPMG observation

The proposal reflects a significant increase in the tax imposed on jet fuel used in noncommercial business aviation.

Improve tax administration

Enhance accuracy of tax information

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

Section 6011(e)(2) provides that the Treasury Secretary generally may issue regulations that require electronic filing ("e-filing") of returns (as opposed to paper filing of returns) if the taxpayer files a minimum number of returns during a calendar year. Under section 6011(e)(1), however, the Secretary generally may not require individuals, estates, and trusts to e-file their income tax returns. An exception to this rule is provided in the case of individual income tax returns filed by a tax return preparer that reasonably expects to file over 10 individual income tax returns during the calendar year. Taxpayers may request waivers of the electronic filing requirement if compliance with the requirement would result in undue financial burden on the taxpayer.

According to the Green Book, enhancing the accuracy of tax information can improve IRS service, boost compliance, and modernize tax administration. Expanding electronic filing can provide uniform data to the IRS, improve audit targeting and reduce the burden on compliant taxpayers. This could increase satisfaction and confidence in the filing process. The proposal would broaden the Secretary's authority to require electronic filing, which would aid the IRS's compliance risk assessment process and allow for more efficient tax administration.

Under the proposal, electronic filing would be required for returns filed by taxpayers reporting larger amounts or that are complex business entities, including:

- Income tax returns of individuals with gross income of $400,000 or more
- Income, estate, or gift tax returns of all related individuals, estates, and trusts with assets or gross income of $400,000 or more in any of the three preceding years
- Partnership returns for partnerships with assets or any item of income of more than $10 million in any of the three preceding years
- Partnership returns for partnerships with more than 10 partners
- Returns of real estate investment trusts (REITs), real estate mortgage investment conduits (REMICs), regulated investment companies (RICs), and all insurance companies
- Corporate returns for corporations with $10 million or more in assets or more than 10 shareholders

The proposal also would require e-filing of the following forms:

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

In addition, the proposal would require return preparers who expect to prepare more than 10 corporation income tax returns or partnership returns to file such returns electronically and would authorize the Secretary to determine which additional returns, statements, and other documents must be e-filed to ensure the efficient administration of the internal revenue laws without regard to the number of returns that a person files during a year.

The proposal would be effective for forms and returns required to be filed after December 31, 2024.

KPMG observation

Treasury Regulations sections 301.6011-3 and 301.6011-5 were finalized in February 2023. These final regulations amended e-filing rules for taxpayers required to file returns of any type, except for individual, estate, and trust returns. The new final regulations lowered the electronic-filing threshold thereby increasing the returns that will be filed electronically. These regulations are effective for returns filed in calendar year 2024.

Improve information reporting for reportable payments subject to backup withholding

Backup withholding applies to a reportable payment if the payee does not provide their taxpayer identification number (TIN) to the payor as required. The IRS can only mandate the provision of the TIN under penalties of perjury for certain types of income such as interest, dividends, and broker-reported amounts. For these types of payments, payees must provide a certified TIN using Form W-9. For other reportable payments subject to backup withholding, payees can provide their TINs in different ways, including orally, unless the IRS has informed the payor that the provided TIN is incorrect. This applies to payments under sections 6041, 6041A, 6050A, 6050N, and 6050W.

As explained by the Green Book, backup withholding is intended as an enforcement tool to ensure payors and payees comply with reporting obligations. Requiring payees to certify their TINs on a Form W-9 or its equivalent reduces the enforcement needed to ensure accuracy. Information reporting increases compliance by providing taxpayers with the necessary information to complete their tax returns accurately and by giving the IRS data to verify compliance.

The proposal would also treat all information returns subject to backup withholding similarly. Specifically, the IRS would be permitted to require payees of any reportable payments to furnish their TINs to payors under penalty of perjury.

The proposal would be effective for payments made after December 31, 2024.

Amend the centralized partnership audit regime to permit the carryover of a reduction in tax that exceeds a partner's tax liability

Current law

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

KPMG observation

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

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

KPMG observation

Because partnerships subject to the centralized partnership audit rules generally must file AARs rather than amended returns, this issue potentially negatively affects many more taxpayers than those subject to an IRS audit. As one example, partners of partnerships that file AARs to apply new and favorable retroactive legislation and regulations may receive adjustments from the partnership that generate net decreases for those partners exceeding their tax liability for the reporting year. If the partner is unable to obtain a refund of the excess, or to carry back or forward the excess, in such a situation, the partner would experience the type of disparity of the type the proposal describes between an adjustment's substantive tax treatment under the centralized partnership audit rules, as compared to its treatment outside of those rules.

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

The proposal would be effective on the date of enactment.

KPMG observation

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

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

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

Incorporate chapters 2/2A in centralized partnership audit regime proceedings

The centralized partnership audit regime, as enacted by the Bipartisan Budget Act of 2015 (BBA), applies to chapter 1 income tax, but does not apply with respect to taxes imposed under chapter 2 (SECA) and chapter 2A (NIIT). Any partnership adjustment determined under the BBA for purposes of chapter 1, however, must be considered for purposes of determining any chapter 2, 2A tax, to the extent such adjustment is relevant to such determination. Therefore, although the BBA establishes a centralized audit and adjustment regime for partnerships, the rules currently separate the treatment of chapter 1 and chapter 2/2A adjustments for reporting, tax calculation, and assessment purposes. This disparate treatment requires taxpayers to file multiple tax returns to meet their filing obligations and requires the IRS to follow separate proceedings to meet its enforcement obligations.

In general, the IRS must determine partnership adjustments impacting the Chapter 1 liability of any partner by conducting a BBA proceeding at the partnership level. At the conclusion of the BBA proceeding, the IRS generally assesses and collects tax from the partnership in the form of an imputed underpayment, unless the partnership elects to push out the adjustments to its reviewed year partners. In contrast, with respect to Chapters 2/2A taxes that result from a BBA proceeding, the IRS must assess and collect these taxes from individual partners, rather than the partnership. According to the Green Book, these cumbersome procedures, which require linking impacted partners' returns to the BBA return under examination and in some case require examinations of partners' returns, are contrary to the intent that the BBA streamline tax administration of partnership examinations. Furthermore, for partnerships that file administrative adjustment requests (AARs) and push out adjustments to reviewed year partners or for partners that file amended returns under the modification procedures, such partners must separately amend their reviewed year income tax returns to pay any Chapter 2/2A taxes attributable to the adjustments made on the AAR or in the partnership proceeding.

The proposal would expand the scope of the BBA beyond Chapter 1 by:

- Amending the definition of a BBA Partnership-Related-Item to include items that affect a person's Chapter 2/2A taxes
- Applying the sum of the highest rates of tax in effect for the reviewed year under section 1401(b)(1) and (b)(2) to these items

The proposal would be effective after the date of enactment for all open tax years.

KPMG observation

Many questions remain as to how the proposed amendments would be implemented and how they would affect the BBA regime, such as whether the rules relating to the push-out election under section 6226 and the rules relating to modifications of the imputed underpayment under section 6225 also would be amended. Under current law, partners that receive push out adjustments or that file amended returns (or the alternative to amended returns) in modification are required only to pay chapter 1 tax. The proposed change could lead to rethinking and redrafting substantial parts of the BBA regime.

Allow partnerships to resolve audits earlier

The centralized partnership audit regime, as enacted by the Bipartisan Budget Act of 2015 (BBA), generally applies to the examination of partnership returns. Prior to making an adjustment to a partnership return, the BBA generally requires the IRS to issue a Notice of Proposed Partnership Adjustment (NOPPA) followed by a Notice of Final Partnership Adjustment (FPA). An FPA may not be mailed earlier than 270 days after the date on which the NOPPA is mailed; however, the partnership may waive that 270-day prohibition.

Under the BBA, a partnership is liable to pay an "imputed underpayment" (IU) based on adjustments made to the partnership return, unless the partnership timely elects to push out the adjustments under section 6226. A partnership has 45 days from the date of the FPA to make the "push-out" election. If the partnership timely elects to push out the adjustments, the partnership is not liable for the IU and the IRS cannot assess the IU against the partnership.

The Green Book explains that partnerships may not make a push out election until the issuance of an FPA even if the partnership does not plan to dispute the adjustment proposed in a NOPPA. According to the Green Book, both partnerships and the IRS would save time and resources if partnerships had the option, but not the requirement, to resolve an audit by pushing out the adjustments at an earlier point in cases when there is no dispute regarding the adjustments.

The proposal would allow a partnership to make an election to push out the adjustments after the issuance of the NOPPA until 45 days after the issuance of the FPA.

The proposal would be effective upon enactment.

KPMG observation

By statute, the IRS must wait 270 days after issuing the NOPPA before the IRS can issue an FPA. However, the statute also gives the partnership the ability to waive this 270-day prohibition. The partnership makes this waiver on Form 8981, *Waiver of the Period under IRC Section 6231(b)(2)(A) and Expiration of the Period for Modification Submissions Under IRC Section 6225(c)(7)*. If the partnership agrees with the adjustments proposed in the NOPPA and files the Form 8981, the IRS can immediately proceed to issuing the FPA, which triggers the ability for the partnership to make the push-out election.

Given the ability to waive the 270-day prohibition, it is not clear why the government believes this proposal would save a significant amount of time. The proposal may alleviate the need for the partnership to file, and for the IRS to process, the Form 8981. Although the preparation of the Form 8981 is relatively straight-forward, the partnership must electronically submit the form through the IRS BBA online "portal." Registering for access to the BBA portal can be cumbersome.

If the proposal were enacted as is, the change could impact the cease-to-exist rules under Treas. Reg. §301.6241-3. Section 6241(7) provides that if a partnership ceases to exist before a partnership adjustment "takes effect, " such adjustment shall be considered by the former partners of such partnership. Treas. Reg. 301.6241-3(c) defines "take effect" for this purpose to include when the adjustments are finally determined as described in 301.6226-2(b)(1). That regulation provides the adjustments are "finally determined" either 90 days after the date of the FPA or the date judicial review is complete. Without an FPA, it is not clear based on the existing regulations when partnership adjustments would be "finally determined" and therefore "take effect" for purposes of the cease-to-exist rules.

Treas. Reg. 301.6241-3(b)(3) provides that a determination a partnership has ceased to exist is not effective if the partnership has made a valid push-out election "in response to a notice of final partnership adjustment. . . ." If the proposal is enacted as is and the partnership makes a push-out election prior to the issuance of the FPA, the rule under Treas. Reg. §301.6241-3(b)(3) would appear, on its face, not to apply. In that case, the IRS could determine the partnership ceases to exist even if a valid push-out election is made, and may require former partners to take into account the adjustments.

Modify requisite supervisory approval of penalty included in notice

Under section 6751(b)(1) of the Code, no penalty 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 th[e Secretary may designate. As with any general rule, there are several exceptions. Section 6751(b)(2) explains that the first exception applies to any addition to tax under: (1) section 6651 for a failure to file or a failure to pay tax; (2) section 6654 for a failure by an individual to pay estimated income tax; (3) section 6655 for a failure by a corporation to pay estimated income tax; or (iv) section 6662 relating to an overstatement of certain qualified charitable contributions. Section 6751(b)(2) goes on to state that the second exception applies to any other penalty automatically calculated through electronic means.

Under current law, however, courts have construed supervisory approval standards differently, leading to conflicting rulings, taxpayer uncertainty, and calls for clearer standards.

According to the Green Book, the proposal addresses the critical issue of timing as it relates to the supervisory approval of penalties under section 6751(b):

- **Pre-assessment review in the Tax Court:** If penalties are included in a notice from which the Tax Court can review the proposed penalty, the penalty can be approved at any time prior to the issuance of that notice.

- **Penalties raised in Tax Court after petition:** If a penalty is raised in the Tax Court and if supervisory approval is obtained before doing so, the IRS may raise the penalty in court.

- **Penalties not subject to pre-assessment review in the Tax Court:** If a penalty is not subject to Tax Court review prior to assessment, supervisory approval can occur at any time before assessment.

For purposes of the proposal, the term immediate supervisor includes any individual that is at a higher level in the management chain or others responsible for review of a potential penalty. Finally, the proposal would eliminate the written approval requirement under section 6662 for underpayments of tax, section 6662A for understatements with respect to reportable transactions, and section 6663 for fraud penalties.

The proposal would be effective upon enactment.

Modify the requirement that general counsel review certain offers in compromise

Section 7122 authorizes the Secretary to enter into an agreement with a taxpayer that settles the taxpayer's tax liabilities for less than the full amount owed if the taxpayer's case has not been referred to the Department of Justice. Such an agreement is known as an offer in compromise (OIC). The IRS is authorized to compromise a liability on grounds of doubt as to liability, doubt as to collectability, or the promotion of effective tax administration. Section 7122(b) requires the General Counsel of the Department of the Treasury, or their delegate, to review and provide an opinion in support of OICs when the unpaid amount of tax assessed (including any interest, additional amount, addition to tax, and assessable penalty) is $50,000 or more. The General Counsel has delegated legal review of OICs to the Chief Counsel of the IRS, who has delegated that authority to the Small Business/Self-Employed Division Counsel (Counsel).

The Green Book observes that the IRS receives thousands of OIC applications every year and must verify that the requirements for an OIC are met prior to proposing acceptance. The concern stated with current law is that the time Counsel spends on reviewing offers already reviewed by other IRS employees may delay acceptance of offers, which may result in financial uncertainty or harm to taxpayers, while providing no additional protection of taxpayer rights.

The proposal would amend section 7122(b) to repeal the requirement that General Counsel review all offers in compromise when the unpaid amount of tax assessed (including any interest, additional amount, addition to tax, or assessable penalty) is $50,000 or more and instead authorize the Secretary to require Counsel review of offers in compromise only in cases that the Secretary determines present significant legal issues.

The proposal would be effective for offer in compromise applications submitted after the date of enactment.

KPMG observation

By removing the OIC review threshold, discretion is placed solely with Treasury to determine whether a specific OIC warrants review by Counsel. Seemingly, as stated in the Green Book, this will allow OICs, when the amount of unpaid tax is $50,000 or more, to move through the IRS administrative process more quickly, as Counsel is no longer required to review based solely on the amount of tax due. Further, the $50,000 tax assessment threshold would logically encompass a greater number of taxpayers seeking OICs today than it did when the current $50,000 threshold was enacted in 1996. As the proposed law change only references the undefined term "significant legal issues," one would anticipate corresponding regulations, or at the least informal guidance or procedures, to be issued to set expectations on, and to establish parameters applicable to, when Treasury intends to seek Counsel review on an OIC.

Simplify foreign exchange gain or loss rules and exchange rate rules for individuals

Personal transactions denominated in a foreign currency

Section 988, which provides rules for ordinary income or loss from foreign currency transactions, is generally only applicable to business or investment transactions (i.e., expenses properly allocable to the foreign currency transaction meet the requirements of section 162 or section 212). Personal transactions are not covered under section 988 other than a limited exemption which applies when the gain on the personal transaction does not exceed U.S. $200. A personal transaction generally means any transaction entered by an individual that is not a business or investment transaction. The exemption for gains of no more than $200 was enacted by the Tax Reform Act of 1986. Personal transactions when the gain exceeds $200 are governed by the rules of pre-1986 case law and subsequent developments of that law through cases and IRS administrative guidance.

As an example, an exchange gain attributable to currency fluctuations may be recognized by a U.S. individual resident upon repayment of a foreign-currency-denominated mortgage on the individual’s principal residence abroad, but any loss is generally treated as a non-deductible personal loss. When the individual sells the residence the gain, including the amount attributable to foreign currency fluctuations, from the sale of the residence may be taxable to the individual, while foreign currency loss on repayment of the foreign-currency-denominated mortgage is a non-deductible personal loss. Conversely, it is possible to have a non-deductible personal loss on the sale of the home and a taxable gain on the repayment of the foreign-currency-denominated mortgage. This could lead to the recognition of a taxable gain in situations when no economic gain was realized.

The proposal would allow individuals to deduct foreign currency losses realized with respect to mortgage debt secured by a personal residence. The deduction would be limited to the extent of any gain taken into income on the sale of the residence because of foreign currency fluctuations. Since an individual may own a personal residence outside the United States that is secured by a foreign currency-denominated mortgage whether or not the individual lives abroad, the proposal would not be limited to individuals who live and work abroad.

The proposal would also seek to simplify foreign currency rules by increasing the personal exemption amount for foreign currency gain from $200 to $600, to reflect inflation since 1986. The amount would be indexed for inflation annually going forward.

The proposal would be effective for tax years beginning after December 31, 2024.

KPMG observation

While foreign exchange gains or losses on a taxpayer’s personal residence are determined under section 988 or the pre-1986 foreign exchange gain or loss rules that predate the enactment of section 988, foreign exchange gains or losses with respect to a foreign rental property of a taxpayer are generally determined under the section 987 rules for branch transactions. Section 987 provides special rules for a qualified business unit (QBU) as defined in section 989 that operates in a functional currency other than the U.S. dollar. Other business or investment activities carried out by an individual in a functional currency other than the U.S. dollar, such as maintaining a foreign brokerage account, are also subject to the rules of section 987.

The IRS has issued proposed regulations under section 987 relating to the determination of taxable income or loss and foreign currency gain or loss of a qualified QBU which if finalized, would generally apply to tax years beginning on or after January 1, 2025. The section 987 rules, when applied to individuals, result in significant complexity and compliance burden. The administration's proposal and the proposed section 987 regulations would not alleviate this burden. Despite several revisions of the proposed section 987 regulations and the applicability date of the section 987 regulations being deferred several times, the complexity remains.

Translating compensation received in foreign currency into U.S. dollars

Under current law, individual taxpayers are required to translate items of income or expense received or paid in a foreign currency to U.S. dollars for the purpose of calculating taxable income. Generally, the IRS requires individuals to use the spot rate on the date the amount is received, or the expense is paid. The Green Book provides the following example:

> [A] U.S. citizen working abroad receiving a salary denominated in Euros every two weeks must translate each deposit into U.S. dollars at the spot rate on the date each payment is received. Consequently, the U.S. citizen must use 26 different spot rates to calculate annual compensation income to file a U.S. tax return.

The proposal would alleviate this burden by allowing individuals living and working abroad to use an average rate for the year to calculate qualified compensation received in a foreign currency. The proposal also provides that such individuals (including retired individuals) may use an average rate for the year other items of income or expense as specified in regulations. The proposal anticipates that the average rate generally would be available for annual ordinary recurring payments.

The proposal would be effective for tax years beginning after December 31, 2024.

KPMG observation

Although the Code requires taxpayers to translate items of income and expense that are received or paid in a nonfunctional currency into their functional currency, exchange rates to be used for the translation are specified only with respect to certain types of transactions. Clarification that an average rate for the year applies to qualified compensation received would help individual taxpayers accurately determine the taxable amount of compensation denominated in a foreign currency for U.S. tax purposes and help to ease the compliance burden.

However, the scope of the application of the proposal to "retired individuals" is not clear and further information as to what constitutes qualified compensation would be required. In addition, no reference is made in the proposal to compensation received by individuals living or working in the United States which is often the case for U.S. individuals who currently or previously were employed by a foreign employer and receive current compensation or deferred compensation paid in a foreign currency.

Modernize reporting with respect to foreign tax credits to reduce burden and increase compliance

The Green Book proposal to modernize reporting of foreign tax credits and expand the Secretary's regulatory authority to require taxpayers to furnish information relating to the verification and computation of the foreign tax credit (FTC) consists of several changes.

First, the proposal would clarify rules related to foreign tax redetermination (FTR). Specifically, the proposal would (1) clarify that FTRs include changes in the liability for foreign income taxes and other changes that affect the U.S. tax liability; (2) clarify that the Secretary would provide the form and manner of notification and have authority for alternative adjustments to account for FTRs (i.e., special rules for FTRs for taxpayers claiming FTCs but reporting foreign income taxes to their owners); (3) provide that the Secretary may provide for the assessment and collection of U.S. tax liabilities as a result of an FTR in the year of the FTR and under deficiency procedures; and (4) provide that the Secretary may provide alternative adjustments, such as appropriate netting or offsetting of adjustments, overpayments, underpayments, and interest, in different years with respect to FTRs reportable in the same tax year.

Second, the proposal would extend the statute of limitations to report information relating to FTCs and FTRs to three years after the date of the Secretary's receipt of the required information and impose penalties for failing to report an FTR and/or failing to respond to a request for more information by the IRS. In the case of a failure to report an FTR, the penalty would be equal to the greater of 5% or $10,000 and 20% in the case of willful failures. In the case of a failure to respond to a request for information from the IRS relating to the substantiation of an FTC or FTR, the penalty would be equal to the greater 5% or $10,000 after 90 days of failing to respond and a penalty increased by the greater of 5% or $10,000 for each subsequent 30-day period (up to a maximum of the greater of 25%, or 40% in the case of willful failures, or $50,000).

Finally, similar to the FY 2024 Green Book proposal, the FY 2025 Green Book proposal would increase the threshold for excepting certain FTC rules and reporting requirements for U.S. individuals to $600 or, in the case of a join return, to $1,200 (the threshold would be indexed for inflation).

The increased threshold for the exception to certain FTC rules and reporting requirements would be effective for foreign income taxes paid or accrued in tax years beginning after December 31, 2024. The remaining changes in this proposal would apply to tax years beginning after the date of enactment (including with respect to FTRs occurring in such tax years that relate to prior years).

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

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

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

The proposal would give officers and employees of BEA access to FTI of those sole proprietorships with receipts greater than $250,000 and of all partnerships. No BEA contractor would have access to FTI. The proposal would also give BLS officers and employees expanded access to certain business FTI (and tax-exempt entities).

The proposal would require information safeguards. Specifically, the proposal would require any FTI to which BEA and BLS would have access, either directly from IRS, from the Census Bureau, or from each other, to be used for statistical purposes consistently with the Confidential Information Protection and Statistical Efficiency Act of 2002 (CIPSEA). The Census Bureau, BLS, and BEA, along with State agencies would be subject to taxpayer privacy law, safeguards, and penalties.

The proposal would be effective on the date of enactment.

Expand TIN matching and improve child support enforcement

The Taxpayer Identification Number (TIN) Matching Program is a pre-filing service offered by the IRS for payors of certain reportable payments subject to the backup withholding provisions of section 3406. The TIN Matching Program enables taxpayers required to file certain information returns to validate TIN and name combinations prior to submission of the information returns.

No information other than a numerical indicator for the validity of the match is disclosed. The TIN Matching Program only applies to reportable payments under section 3406. Therefore, the Program does not apply to a number of widely-used information returns, including Form 1098, *Mortgage Interest Statement*; Form 1098-T, *Tuition Statement*; Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*; Form 5498, *IRA Contribution Information*, 1099-G, *Certain Government Payments*; Form 1099-S, *Proceeds from Real Estate Transactions*, and Form 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding*.

The proposal would amend section 6103 to permit TIN matching for filers of all information returns requiring the reporting of names and TINs. The proposal also amends section 6103(1) to allow Child Support Enforcement Agencies (CSEs) to share all information they receive with their contractors, subject to the same confidentiality and safeguard provisions applicable under current law. It would also provide Tribal CSEs with the same access to the same return information as Federal, State, and local CSEs, and would amend section 6402(c) to provide Tribal CSEs with access to the Federal tax refund offset program.

This proposal would be effective upon enactment.

KPMG observation

Various stakeholders over the years have urged the IRS to expand the TIN Matching Program. There has been uncertainty whether the IRS has the legal authority to do so beyond its current scope, which limits the program to payers of amounts potentially subject to backup withholding. Providing the legal framework to expand the program should be welcome news to many and allow a wider number of information return filers the opportunity to verify name-TIN combinations upfront, thereby avoiding IRS notices and possible penalties for filing information returns with incorrect TINs.

Clarify that information previously disclosed in a judicial or administrative proceeding is not return information

Section 6103(a) prohibits the disclosure of returns and return information unless a provision of Title 26 provides otherwise. Section 6103 contains several exceptions to this general rule. These exceptions authorize the disclosure of specific return information in specific circumstances; however, the scope of these exceptions can be limited.

For example, although section 6103(h) permits certain disclosures of returns and return information in judicial and administrative tax proceedings, neither this exception nor any other section 6103 exception explicitly creates a general authorization to redisclose return information that has previously been disclosed during a judicial or administrative proceeding and become public information as a result. In abusive transaction cases, it is common for the Department of Justice to issues press releases as a tool to encourage taxpayer compliance across a broad audience. For example, by announcing the filing of a complaint in abusive tax transactions cases, the government alerts taxpayers that certain transactions and conduct will draw the attention of the government and that the government will seek to enjoin those transactions and conduct. Such press releases relating to information previously disclosed in a judicial or administrative proceeding and that has become public record are not explicitly referenced in section 6103.

The proposal would make the following changes:

- Amend section 6103(b)(2) to clarify that information previously disclosed pursuant to section 6103 in the course of any judicial or administrative tax proceeding and made a part of the public record thereof, including information disclosed in any Notice of Federal Tax Lien filed in accordance with section 6323 of the Code or related filings, is not return information protected from disclosure by section 6103.

These proposals would be effective upon enactment.

KPMG observation

The proposal is focused, in part, on press releases issued by the government relating to information previously disclosed in a judicial or administrative proceeding and that has been made part of the public record. The reference to the public record appears central to the proposal's recommendation to no longer protect this type of information from disclosure. The IRS has argued that tax information placed in the public record in connection with tax administration is no longer confidential and cannot be "disclosed" within the meaning of section 6103(b)(8) if the IRS has already lawfully made such information known in public records during tax administration activities. The absence of express statutory authority in section 6103 for the disclosure of such information, however, has generated conflicting case law in the circuit courts of appeal. Given this uncertainty, the IRS instructs its employees to exercise caution before using the public record exception as a basis for the release of otherwise confidential tax information. See Internal Revenue Manual 11.3.11.12, Information Which Has Become Public Record (June 21, 2022).

Require earlier electronic filing deadlines for certain information returns

Most electronically filed information returns, including those reporting various types of income and financial activities, must be filed with the IRS by March 31 of the year following the reporting year. However, returns and statements related to employee wages and nonemployee compensation have an earlier deadline of January 31. Third parties filing these returns must also provide a copy to payees, usually by January 31, though some forms like Form 1099-B have a deadline of February 15. Individuals typically need to file their income tax returns by April 15 of the following year, but many file earlier, often before the IRS has received the relevant information returns.

According to the Green Book, the current March 31 deadline for most electronically filed information returns limits the IRS's ability to match information reporting to tax returns in real-time. By receiving third-party information earlier, the IRS can detect noncompliance sooner in the filing season, thereby reducing identity theft and fraud. Additionally, providing the IRS with this information when taxpayers receive it can facilitate the electronic use of data during tax return filing season, which can simplify tax preparation and reduce errors.

The proposal amends Section 6071(b) to require information returns made under sections 6041 through 6050z of the Code to be filed on or before the date the returns are required to be furnished to payees and other recipients. The proposal does not include returns and statements required to be filed with respect to nonemployee compensation.

The proposal would be effective for information returns required to be filed after December 31, 2024.

Allow the Tax Court to review all evidence in innocent spouse relief cases

A married taxpayer who files a joint return may be eligible for innocent spouse relief and relieved from all or a portion of any tax liability that evolved from the actions of their spouse. The IRS considers several factors when determining whether to grant innocent spouse relief. These factors include knowledge, financial hardship, and whether the spouse requesting relief separated or divorced from the spouse who misrepresented the couple's joint income or underpaid taxes. Taxpayers are required to complete a form and submit documentation to request innocent spouse relief. This form and documentation ultimately become part of the IRS's administrative record.

Taxpayers may petition the Tax Court for review of a denial of innocent spouse relief. Section 6015 \permits a *de novo* standard of review for innocent spouse relief determinations, enabling the Tax Court to conduct a new analysis without deferring to the IRS's decision. However, the *de novo* scope of review is limited to the administrative record at the time of the IRS's determination and any newly discovered or previously unavailable evidence. This means information previously available but not included in the administrative record is excluded from the scope of the Tax Court's review.

The Green Book explains that the current statutory limitation on the scope of review in innocent spouse relief cases hinders the Tax Court's ability to fully review cases for taxpayers who did not provide a complete administrative record or critical documentation to the IRS before the final determination. This may be due to taxpayers overlooking evidence, being hesitant to share certain information with the IRS, or the administrative record not being fully developed. Thus, the outcome of the case may heavily rely on the IRS's factual development and analysis of the case. According to the Green Book, expanding the scope of Tax Court review could reduce the risk of taxpayers bearing tax liability due to an incomplete or inaccurate administrative record and could improve due process in innocent spouse cases, resulting in fairer outcomes for taxpayers petitioning the Tax Court for review.

The proposal would eliminate statutory limitations on the scope of information that the Tax Court may review in innocent spouse relief cases.

The proposal would be effective on the date of enactment.

Permit electronically provided notices

The IRS sends notices to taxpayers via mail for various reasons, such as changes to their accounts, issues with their tax returns, requests for information or payment, or other important information. These notices also inform taxpayers about crucial deadlines and their statutory rights.

The Code requires that certain notices be sent by certified or registered mail to the taxpayer's last known address. Some of these notices give taxpayers the right to challenge the IRS's proposed administrative actions, including those that could occur in the Independent Office of Appeals or in a federal court of law.

According to the Green Book, the IRS is modernizing by digitizing forms, creating online accounts, and allowing taxpayers to elect to correspond electronically. Allowing taxpayers to choose to receive IRS notices electronically can reduce administrative burdens on the IRS and taxpayers by ensuring these notices are delivered and retained through a second medium. However, even when a taxpayer chooses to receive notices electronically, the statutory requirement that certain notices must be sent by certified or registered mail to a taxpayer's last known address will not be satisfied.

The proposal would amend all Code provisions which require notice by mail (including notice by certified or registered mail sent to the taxpayer's last known address) such that electronic notice pursuant to the taxpayer's election or preference will have the same legal effect as a mailed notice. The IRS would still be obligated to send these notices by mail unless the taxpayer elected to receive such notices only electronically.

The proposal would be effective as of December 31, 2024.

Reform federal grants to low-income taxpayer clinics

The low-income taxpayer clinic (LITC) grant program provides financial support for the development and existence of LITCs. These clinics provide free or nominal-cost representation to low-income taxpayers involved in tax disputes with the IRS and educate individuals who speak English as a second language (ESL) about their tax rights and responsibilities.

Under section 7256 of the Code, the Secretary, subject to the availability of appropriated grant funds, is authorized to provide grants at or below $100,000 per clinic per year—not to exceed three years. Since the LITC grant program was established in 1998, this limitation has maintained a ceiling of $100,000 per year and has not been indexed for inflation. This changed, however, when the Consolidated Appropriations Act (CAA) was passed in 2023. Specifically, the CAA provides LITCs with grants up to $200,000. In addition, the Code now requires LITCs to match its grant funds on a dollar-for-dollar basis.

The proposal would increase the annual limitation on grants to a single clinic to $200,000, indexed for inflation. In addition, while the applicable percentage of matching funds generally would remain at 100%, the Secretary would be granted authority to reduce the matching requirement to as low as 25%, when doing so would serve the mission of the LITC program.

The proposal would be effective upon enactment.

Improve tax compliance

Address taxpayer noncompliance with listed transactions

Generally, the IRS must assess a tax within three years after the date the return is filed, subject to several exceptions. One such exception applies if a taxpayer fails to include, on any return or statement, information required about a listed transaction. In that case, the IRS has more time to assess any tax on such listed transactions. The amount of additional time depends on when the information related to the listed transaction is ultimately furnished to the IRS. See section 6501(c)(10).

A "listed transaction" is a transaction that is the same as, or substantially similar to, a transaction identified by the IRS in published guidance as a potential tax avoidance transaction. The consequences of a transaction becoming a listed transaction include (1) taxpayers generally are required to disclose their participation in these transactions on Form 8886, *Reportable Transaction Disclosure Statement*, and face penalties for failure to disclose, (2) taxpayers may face enhanced penalties with respect to underpayments of tax attributable to these transactions, and (3) persons who are "material advisors" with respect to these transactions are required to maintain independently a list identifying each person with respect to whom the advisor acted as a material advisor and also to provide the list to the IRS upon request.

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

> In a typical case, an intermediary entity borrows funds to purchase the stock of the C corporation from the C corporation's shareholders, and the consideration received by the C corporation from the sale of its assets is effectively used to repay that loan. These transactions are structured so that when a C corporation's assets are sold, the C corporation is ultimately left with insufficient

assets from which to pay the tax owed from the asset sale. In many cases, the intermediary does not pay the corporate income tax liability and is judgment-proof, frustrating the IRS's ability to collect taxes that are legally owed.

The proposal would extend the general statute of limitations on assessment under section 6501(a) from three to six years for returns reporting benefits from listed transactions. It appears the taxes that could be assessed during the extended period would not be limited to those attributable to a listed transaction but rather would cover the entire return, *i.e.*, the six-year period would appear to apply to any tax attributable or issue with respect to the income tax return. In addition, for situations when no required disclosure is made on a return that includes a listed transaction, the assessment period under section 6501(c)(10) would be increased from one year to three years from the date that disclosure is made or the date that a material advisor has reported the transaction in response to an IRS request. The taxes that could be assessed during the extended period would be limited to taxes with respect to the listed transaction. The two proposed changes to the statute of limitations on assessment would be effective on date of enactment and are estimated by Treasury to raise approximately $650 million over the 10-year budget window.

KPMG observation

The justification for the potential extension of the statute of limitations for all items on a taxpayer's return (not just those arising from a listed transaction) is unclear. The listed transaction rules apply when a taxpayer has engaged in certain, designated "tax-avoidance" transactions to reduce tax liability. However, most other instances in which a taxpayer misreports tax liability are addressed by the general statute of limitation rules, and it is not clear why engaging in a listed transaction should alter the general statute of limitation rules for any items on a taxpayer's return not tied to that listed transaction.

The proposal would also impose secondary liability on selling shareholders who directly or indirectly sell or dispose of a 50% or greater interest (a "controlling interest") in the stock of an "applicable C corporation" for payment of the C corporation's U.S. federal income taxes (plus interest, additions, and penalties) to the extent of the sales proceeds received by the shareholders. The liability would arise only after the applicable C corporation was assessed these amounts with respect to any tax year within 12 months before or after the date the stock was sold or disposed of, and only after the applicable C corporation did not pay such amounts within 180 days after assessment. For these purposes, an "applicable C corporation" is a C corporation (or a successor) two-thirds of whose assets are comprised of cash, passive investment assets, or assets that are the subject of a contract of sale (or whose sale has been substantially negotiated on the date that the stock is sold or disposed of). Exceptions would apply to dispositions of publicly-traded C corporation, REIT, or RIC stock, and to C corporation shares acquired by publicly-traded acquirers. The proposal would close the tax year of the applicable C corporation as of the later of a disposition of the controlling interest in its stock or on a disposition of all its assets. In addition, an additional year would be added to the statute of limitations on assessment against the selling shareholders. The secondary liability proposal would be effective for sales of controlling interests occurring on or after April 10, 2014, and is estimated to raise approximately $6.0 billion over the 10-year budget window.

KPMG observation

The first thing to note about the secondary liability proposal is its retroactive effective date—it is proposed to be effective for sales of controlling interests in stock of an applicable C corporation occurring on or after April 10, 2014 (more than nine years prior to the date this proposal was released).

The second thing to note is that recent court decisions have concluded that certain IRS notices identifying listed transactions are rules subject to the Administrative Procedure Act's notice-and-comment rulemaking process. The failure to follow notice-and-comment requirements have led these courts to "set aside" and vacate the IRS notices. See, e.g., *Mann Construction, Inc. v. United States*, 27 F.4th 1138 (6th Cir. 2022) (invalidating Notice 2007-83) and *Green Valley Ranch Investors, LLC v. Comm'r*, 159 T.C. No. 5 (2022) (invalidating Notice 2017-10).

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

While the secondary liability proposal would change the existing rules, the circumstances in which it would apply are similar to those described in Notice 2008-111, though the proposal would cast a somewhat wider net. For example, the Notice addresses situations when at least 80% of a C corporation's stock is sold within a 12-month period, while the proposal would relax the threshold to dispositions of a 50% or greater interest. In addition, the Notice identifies a transaction as a midco transaction only as to those transactional participants who know or have reason to know (or who are deemed to have reason to know) that the corporation's federal income tax obligation with respect to the disposition of its built-in gain assets will not be paid. The proposal, however, lacks a similar knowledge-based limitation. The proposal's exceptions track the safe harbors in the Notice.

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

Impose an affirmative requirement to disclose a position contrary to a regulation

Section 6662(b)(1) imposes a 20% accuracy-related penalty on underpayments attributable to the disregard of a rule or regulation. In general, this portion of the accuracy-related penalty does not apply if the taxpayer adequately discloses, via Form 8275-R, *Regulation Disclosure Statement,* a tax position contrary to a regulation when it files its return. To avoid the application of this penalty, a position contrary to a regulation must represent a good faith challenge to the validity of the regulation, have a reasonable basis, and be properly substantiated. If the position contrary to a regulation relates to a reportable transaction, the taxpayer must also report the transaction in accordance with the reportable transaction rules. The accuracy-related penalty is subject to a reasonable cause and good faith exception.

Current law treats the disclosure of a position contrary to a regulation to avoid imposition of the accuracy-related penalty. There is no affirmative obligation for taxpayers to inform the IRS that they are taking such a position. The Green Book's stated observation is that "in recent years" a growing number of taxpayers—especially large multinational entities—have taken tax positions on their returns that are contrary to a regulation and that such positions are difficult for IRS to identify if the taxpayer chooses not to disclose them for penalty protection purposes. As the administration views it, a taxpayer could forgo filing a Form 8275-R for penalty protection in hopes of avoiding scrutiny for taking a position contrary to a regulation.

The proposal would impose an affirmative requirement on taxpayers to disclose a position on a return that is contrary to a regulation. Except to the extent provided in regulations for failures due to reasonable cause and not willful neglect, a taxpayer who failed to make the required disclosure would be subject to an assessable penalty that was 75% of the decrease in tax shown on the return as a result of the position.

Such a penalty would not be less than $10,000 or more than $200,000, adjusted for inflation. The penalty would not apply if a taxpayer reasonably and in good faith believed that its position was consistent with the regulation. However, the penalty would apply regardless of whether the taxpayer's interpretation of the regulation is ultimately upheld.

The proposal would be effective for returns filed after the date of enactment.

KPMG observation

The proposed change would add to the growing list of disclosure obligations placed upon taxpayers as part of their annual income tax compliance and other federal tax compliance obligations, and it highlights the frequently stated premise that the IRS will be better equipped to conduct examinations and to more fairly administrate the tax laws if taxpayers disclose more information. With all the current disclosure obligations on taxpayers, adding another obligation could raise a question as to the use and value of current disclosure obligations. Presumably the government would contend that this disclosure proposal is different than others as it requires taxpayers to disclose tax positions that, on their face, are contrary to the law. Most pointedly, because the proposal includes a minimum penalty of $10,000, the proposal would appear to apply a penalty *even if* the taxpayer's interpretation of the regulation was upheld by the IRS Independent Office of Appeals, or by a court of law. Some may express difficulty in justifying a policy when the taxpayer would be subject to a penalty for not disclosing a tax position upon which the taxpayer prevailed on the substantive merits of that tax position (and the taxpayer would not be subject to an accuracy-related penalty).

Require employers to withhold tax on failed nonqualified deferred compensation (NQDC) plans

Under section 409A, an NQDC plan must comply with various requirements including distribution and election timing rules. A failure to satisfy section 409A requirements results in a 20% additional tax and possibly interest to an employee. Currently, employers have no withholding obligation for either the 20% tax or the interest. The proposal would require employers to withhold the 20% tax and any applicable interest.

KPMG observation

The requirement for employers to withhold would make section 409A audits easier for the IRS by allowing an exam at the employer level instead of having to pursue an audit with each individual employee.

Extend to six years the statute of limitations for certain tax assessments

The Green Book lays out a proposal to extend the normal three-year statute of limitations to six years if there is an omission of more than $100 million of gross income. This resembles the extension of the statute under current law (section 6501(e)(1)(A)) for substantial omissions from gross income but would result in a much lower threshold for omission for large taxpayers and could lead to more frequently statute extensions. In describing this proposal, the Green Book specifically mentions the need for a longer statute to handle complex transfer pricing cases.

KPMG observation

The proposed statute extension could undermine IRS Exam's handling of complex cases. As stated in the Green Book, "taxpayers will typically consent to extend their statutes of limitations." While it is true that any given extension of the statute may not extend the limitations period for as long as an examination team might wish, taxpayers are generally willing to continue extending the statute provided that the examination is progressing. Negotiated statute extensions can provide an important tool for case management and act as a potential limit to prolonged uncertainty.

KPMG observation

By predicating the applicable statute on the size of the adjustment, the proposal has the potential to impact the substance of an examination.

Increase the statute of limitations on assessment of the COVID-related paid leave and employee retention tax credits

The Families First Coronavirus Response Act of 2020 (FFCRA) enacted the paid sick and family leave tax credit (the paid leave tax credit) entitling certain employers to a refundable tax credit for the payment of qualified leave wages. The "Coronavirus Aid, Relief, and Economic Security Act of 2020" (CARES Act) enacted the employee retention tax credit (ERTC) entitling certain employers to a refundable tax credit for the payment of qualified wages.

The paid leave tax credit and the ERTC applied to wages paid during the second, third, or fourth quarters of 2020. Subsequent legislation—the "COVID-Related Tax Relief Act of 2020" (Relief Act) and "American Rescue Plan Act of 2021" (ARPA)—extended the paid leave tax credit for qualified leave wages paid during the first, second or third quarters of 2021 and extended the ERTC for qualified wages paid during the first, second, third or fourth quarters of 2021. (The "Infrastructure Investment and Jobs Act of 2021" amended the ERTC to apply only to wages paid prior to October 1, 2021, except for employers in limited circumstances).

Both the paid leave tax credit and the ERTC were claimed on employment tax returns, which generally are filed quarterly on Form 941. The due date for a quarterly Form 941 filing generally is the last day of the month following the quarter to which it applies—e.g., the due date for Form 941 in the first quarter of 2021 was April 30, 2021. The Relief Act expanded ERTC eligibility and applied retroactively to quarters with filing due dates that already had passed. To claim the ERTC for a prior quarter, an employer is required to file an amended employment tax return, generally on Form 941-X, for each earlier quarter.

In general, under section 6511(a) taxpayers must file a claim for credit or refund within the later of three years from the time the tax return was filed or two years from the time the tax was paid. Similarly, the IRS must assess taxes within three years after filing a return. The general period of limitations on assessment does not restart upon the filing of an amended return. For these purposes, if an employment tax return for a period ending with or within a calendar year is filed before April 15 of the succeeding calendar year, the return is considered filed on April 15 of that succeeding calendar year. Thus, an employer that timely filed and timely paid employment tax may file a claim for ERTC with respect to any quarter of 2020 by filing an amended employment tax return, generally Form 941-X, until April 15, 2024. As a result of these timing rules, it is often the case that the assessment period expires at the same time as the period for a taxpayer to file a claim for credit or refund on an amended return.

ARP extended the assessment period from three to five years for any amount attributable to the paid leave tax credit and the ERTC that was improperly claimed. Thus, the limitation period for assessment of erroneous ARP paid leave credits and ERTC will not expire before the date that is five years after the later of (1) the date on which the original return that includes the calendar quarter with respect to which the paid leave credit or ERTC is determined is filed, or (2) the April 15 date on which the return is treated as filed. However, the ARP extension applies only for the second and third quarters of 2021 for the paid leave tax credit and the third and fourth quarters of 2021 for the ERTC. The FFCRA and the CARES Act did not include extensions of the limitations period. Accordingly, the ARP's extended limitations period applies only for two of the six quarters in which an employer may claim the paid leave tax credit and only for two of the eight quarters in which an employer may claim the ERTC.

According to the Green Book, because the current-law three-year limitations period applicable to the paid leave tax credits and the ERTC does not restart when an amended return is filed, a three-year assessment limitations period makes it difficult for the IRS to audit the amended returns and timely assess any tax, if warranted.

To address this concern, the proposal would extend the limitations on the period for the assessment of erroneous paid leave tax credits under the FFCRA and the ERTC under the CARES Act, as amended prior to the ARP, to conform with the same five-year period provided under ARP. Additionally, the proposal would extend the limitations period for the IRS to assess additional income tax from the taxpayer if the taxpayer that claimed the ERC or paid leave tax credit did not make a corresponding downward adjustment to its wage deduction on Forms 1120, 1065, or 1040.

The proposal would be effective on the date of enactment.

KPMG observation

The Tax Relief for American Families and Workers Act of 2024, which passed the House of Representatives in January 2024, contains a provision that would extend the period for the IRS to assess any tax attributable to a credit claimed under section 3134 or under section 2301 of the CARES Act. As of March 14, 2024, the Senate had not considered this bill.

Impose penalties for inaccurate or fraudulent employment tax returns

Section 6676 imposes a civil penalty on claims for refund or credit, equal to 20% of the excessive amount claimed, when a taxpayer submits an erroneous refund or credit claim for income tax. The civil penalty may be rebutted by a showing of reasonable cause, unless any part of the excessive amount is attributable to a transaction lacks economic substance. An excessive amount is the portion of a claim for refund or credit for any tax year that exceeds the amount of such claim allowable for the tax year. Most importantly, the civil penalty does not apply to any portion of the excessive amount subject to the imposition of any component of the accuracy-related penalty or the fraud penalty.

During the COVID-19 pandemic, Congress enacted several refundable credits against employment tax. The employee retention credit, for example, provides a refundable credit against employment taxes for payment of qualified wages. Eligible employers can claim the credit on an original or amended tax return. Also, the leave credit allows employers with less than 500 employees who paid COVID-related sick leave or family leave wages to claim refundable tax credits against employment taxes for qualified leave wages. Notably, there are no civil penalties applied to an erroneous claim for refund or credit of employment taxes.

The proposal would extend the penalty under section 6676 to erroneous claims for refund or credit with respect to employment taxes, and therefore, support sound tax administration and provide parity with existing penalty providing regarding excessive refund or credit claims for income taxes. Moreover, this proposal would help the IRS, who is auditing and conducting criminal investigations related to false employee retention credit claims. As such, extending penalties to improper claims for refunds or credits in employment tax cases, when the reasonable cause exception is not sustained, will likely discourage taxpayers from filing future fraudulent claims.

The proposal would be effective for claims for which the statute of limitations has not expired as of the date of enactment.

Expand and increase penalties for noncompliant return preparation and e-filing and authorize IRS oversight of paid preparers

Under current law, any person who is paid to prepare, or assists in preparing, Federal tax returns must identify themselves on those returns by using a prescribed identifying number. Under the applicable regulations, that number is a valid Preparer Tax Identification Number (PTIN) issued by the IRS. Paid tax return preparers must sign and include their PTIN on the return.

However, although the Code authorizes the IRS to issue PTINs, it does not authorize the IRS to revoke or rescind issued PTINs when the paid tax return preparer misuses or abuses taxpayers and/or the tax system. Furthermore, the IRS does not have authority to address paid tax return preparers who are deemed to be unsuitable to prepare returns based upon a continual failure to comply with their own tax obligations.

Civil penalties and injunctive relief may be used to address preparer noncompliance. In general, penalties must be assessed within three years after the relevant return is filed. The civil penalties applicable to return preparers and the amounts of those penalties are listed below in Table 1.

In addition, although e-file providers must apply with the IRS and pass a suitability check before becoming an authorized e-file provider and receiving an Electronic Filing Identification Number (EFIN), there is no civil penalty on e-file provider misconduct.

KPMG observation

Under Title 31 of the United States Code, the Secretary has the authority to regulate licensed attorneys, CPAs, and enrolled agents and actuaries who practice before the IRS. These regulations are colloquially known as Circular 230. In 2009, Treasury and the IRS amended the Circular 230 regulations to regulate practice of all paid tax return preparers, including preparers that are unlicensed and unenrolled. In 2014, the Court of Appeals for the D.C. Circuit determined that the 2009 amendments to the Circular 230 regulations exceeded the government's authority under Title 31. In 2014, the IRS also introduced its Annual Filing Season Program for non-credentialed return preparers. Prepares can voluntarily participate in the AFS program by completing 18 hours of continuing education and a federal tax law refresher course with accompanying test, after which the preparer will be listed in a database of credentialed return preparers.

KPMG observation

Paid tax return preparers play an important role in tax administration because they assist taxpayers in complying with their obligations under the tax laws. Incompetent and dishonest paid tax return preparers increase collection costs, reduce revenues, disadvantage taxpayers, and undermine confidence in the tax system. The current lack of authority to provide federal oversight on paid tax return preparers results in greater non-compliance when taxpayers who use incompetent preparers or unscrupulous preparers become subject to penalties and interest and incur litigation costs due to the poor-quality advice they receive. The lack of authority also affects government revenues when the resulting noncompliance is not mitigated by the IRS during return processing. Regulation of paid tax return preparers, in conjunction with diligent enforcement, will help promote high quality services from paid tax return preparers, will improve voluntary compliance, and will foster taxpayer confidence in the fairness of the tax system.

The administration's proposal would make the following changes:

- Increase the amount of the tax penalties that apply to paid tax return preparers for willful, reckless, or unreasonable understatements, as well as for forms of noncompliance that do not involve an understatement of tax

- Establish new penalties for the appropriation of PTINs and EFINs and for failing to disclose the use of a paid tax return preparer. A $1,000 penalty would apply for each appropriation of a PTIN, with a maximum penalty of $75,000 for a calendar year. A $250 penalty would apply for each appropriation of an EFIN. Except for failures due to reasonable cause, a $500 penalty would apply for each failure by a taxpayer to disclose the use of a paid tax return preparer and the fees paid to such a preparer

- For all the new or increased penalties in the proposal, the specified dollar amounts, and any applicable annual limitations would be adjusted for inflation

- Expand the authority to determine the suitability of paid tax return preparers applying for identification numbers

- Expand the authority to revoke identification numbers for paid tax return preparers subsequently determined to be unsuitable

- Increase the limitations period during which the penalty for a failure to furnish the paid tax return preparer's identifying number may be assessed from three years to six years

- Clarify the Secretary's authority to regulate the conduct and suitability of persons who participate in the authorized e-file program, including setting standards and imposing sanctions to protect the integrity of the e-file program

This proposal would be effective for returns filed after December 31, 2024.

The proposal would also amend Title 31 to provide the Secretary with explicit authority to regulate all paid preparers of Federal tax returns, including by establishing mandatory minimum competency standards. This proposal would be effective on the date of enactment.

Make repeated willful failure to file a tax return a felony for those with significant tax liability

Under current law, a person with federal tax liability who willfully fails to file a tax return is guilty of a misdemeanor, which is punishable by a term of imprisonment of not more than one year, a fine of not more than $250,000 ($200,000 in the case of a corporation), or both. Further, a person with federal tax liability who willfully fails to file tax returns for multiple years commits a separate misdemeanor offense for each year a tax return is not filed.

The proposal would amend section 7203 of the Code. Namely, any person who willfully fails to file timely required tax returns in any three years within a consecutive five-year period, when the aggregate tax underpayment for such five-year period is more than $250,000, would be subject to a new aggravated failure-to-file criminal penalty. The offense would be classified as a felony, punishable by a term of imprisonment of no more than five years, a fine of up to $250,000 ($500,000 in the case of a corporation), or both.

Non-compliance by high-income taxpayers has a significant corrosive effect on tax administration and collection. A significant portion of the non-filer tax gap—the difference between tax liability and the taxes paid--is attributable to high-income non-filers. As provided in the Green Book, increasing criminal penalties for high-income people who willfully and repeatedly do not file a tax return would provide a more effective deterrent to such blatant tax evasion, encourage voluntary compliance, and help close the tax gap.

The proposal would be effective for tax returns required to be filed after December 31, 2024.

Expand IRS summons authority for large partnerships

The statute of limitations on assessment limits the ability of the IRS to assess additional tax against a taxpayer after a certain period has passed. Generally, the statute of limitations is three years from the filing of the original return. However, for corporate taxpayers that are under examination via the IRS's Large Corporate Compliance program, the statute of limitations on assessment can be suspended via the issuance of a "designated summons".

A designated summons can only be issued under certain limited circumstances and is subject to written approval by the IRS Chief Counsel and select others. Designated summonses must be served at least 60 days before the assessment period expires. The IRS must establish in a judicial enforcement proceeding that prior reasonable requests were made to obtain the information sought from the taxpayer. The taxpayer's statute of limitations is suspended for 120 days following a court's enforcement of the summons. If a court does not enforce the summons, the statute of limitations remains suspended for 60 days following the court proceedings (including a period for appeal of the decision).

The designated summons provisions do not apply to large partnerships, such as complex investment funds and hedge funds. Partnerships examined under the IRS's large partnership compliance program (LPC) are subject to the centralized partnership audit regime, as enacted by the Bipartisan Budget Act of 2015 (BBA), when the determination of any adjustments and the assessment of any tax generally is determined at the partnership, rather than the partner, level.

The Green Book explains that large partnerships are often embedded in complex business structures that require painstaking and time-intensive examination. These structures can involve many tiers of indirect partners, some of which may not be known to the IRS when the examination begins. According to the Green Book, providing designated summonses in examinations of large partnerships will enable the IRS to better enforce the tax law with respect to these large and complex business entities.

The proposal would extend the designated summons provisions to examinations of large partnerships under the LPC or any successor program. In the case of a partnership designated summons, the relevant statutes of limitations under BBA could be extended subject to judicial enforcement.

The administrative procedures for partnership designated summonses would parallel the current procedures applicable to designated summonses issued to corporations, whereby approvals would be required by the IRS Chief Counsel and the IRS Large Business and International Division Commissioner.

The proposal would be effective after the date of enactment.

KPMG observation

The proposal touches on the distinction between section 6235, the statute of limitations for BBA adjustments, and section 6501, the statute of limitations on assessment of tax. Section 6235 provides, in general, no partnership adjustment may be made after three years have passed since the filing of the original partnership return. While a designated summons suspends the period to assess tax under section 6501, current law does not provide a similar suspension for the period to make a partnership adjustment under section 6235.

Address compliance in connection with tax responsibilities of expatriates

Increased enforcement of Form 8854 filing requirement

Section 877A imposes a mark-to-market exit tax on certain individuals who relinquish their U.S. citizenship or cease to be lawful permanent residents (green card holders) after holding their green cards in eight of the prior 15 years if such individuals meet the definition of covered expatriates. They are covered expatriates if they meet any one or more of the following tests:

- They have an average annual net income tax liability for the five tax years preceding the year of expatriation that exceeds a specified amount that is adjusted annually for inflation

- They have a net worth of $2 million or more as of the expatriation date

- They fail to certify, under penalty of perjury, compliance with all U.S. federal tax obligations for the five tax years preceding the tax year that includes the expatriation date

Certain assets of covered expatriates, including deferred compensation items, specified tax deferred accounts and interests in non-grantor trusts, are not subject to the mark-to-market exit tax but are subject to tax under separate rules set out in section 877A.

Covered expatriates are required to file Form 8854, *Initial and Annual Expatriation Statement*, with their tax returns for the year of expatriation and, in certain circumstances, also in subsequent years. One of the purposes of the form is to require covered expatriates to disclose information on their financial assets subject to the mark-to-market exit tax or to the separate rules applicable to certain assets mentioned above. The proposal would provide that where a taxpayer is required to provide Form 8854 to the IRS with their tax return the time for assessment of tax will not expire until three years after the date on which Form 8854 is filed with the IRS. The proposal would subject the filing of Form 8854 to the same statute of limitation rules that apply to other international information returns (e.g., Form 8938, *Statement of Foreign Financial Assets*). Without this rule, the statute of limitations for a covered expatriate's tax return would be three years from the later of the original due date of the return or the date on which the return is actually filed.

The proposal would be effective for tax years beginning after December 31, 2024.

KPMG observation

A report issued in 2020 by the Treasury Inspector General for Tax Administration, entitled *More Enforcement and a Centralized Compliance Effort Are Required for Expatriation Provisions*, concluded that a substantial number of covered expatriates failed to file Form 8854 and that this failure contributed to significant under-reporting of income and assets subject to the mark-to-market exit tax under section 877A. The proposal appears to be targeted at improving compliance and tax collection in relation to covered expatriates.

Authority to provide relief for lower-income dual citizens

Section 877A provides a limited exception to the definition of a covered expatriate for individuals who have been U.S. citizens and citizens of another country since birth and who have been resident in the United States for not more than 10 of the 15 years ending with the year in which they relinquish their U.S. citizenship.

The proposal would grant authority to the IRS to provide relief from the rules for covered expatriates for a narrow class of lower-income dual citizens with limited U.S. ties. This relief would apply only to taxpayers who have a tax home outside the United States and who satisfy other conditions that ensure that their contacts with the United States are limited, and whose income and assets are below a specified threshold.

KPMG observation

The proposal does not specify the income levels or the periods of U.S. residency as opposed to foreign residency that would be required for individuals to qualify for this relief. Nor does the proposal specify whether qualifying individuals would be entitled to complete exemption from the rules applicable to covered expatriates. However, the proposal is a welcome recognition of the compliance problems and attendant costs faced by U.S. citizens living overseas who wish to relinquish their citizenship.

In 2019, the IRS announced relief procedures for certain persons (sometimes referred to as “Accidental Americans”) who have relinquished, or intend to relinquish, their U.S. citizenship and who wish to come into compliance with their U.S. income tax and reporting obligations and avoid being taxed as covered expatriates. The relief outlined in the current proposal would likely expand upon the relief announced in 2019.

Repeal of sailing permit requirement

Most foreign citizens, regardless of their residency status, must obtain a certificate of compliance before departing from the United States. This document, which is generally referred to as a “sailing permit,” confirms the taxpayer’s compliance with their U.S. income tax obligations. The permit is part of Form 1040-C, *U.S. Departing Alien Income Tax Return*, or Form 2063, *U.S. Departing Alien Income Tax Statement*, and must be filed before the individual departs from the United States.

The proposal would repeal the requirement for non-U.S. citizens to obtain a sailing permit. The proposal would be effective for tax years beginning after December 31, 2024.

KPMG observation

It is questionable how many foreign citizens are aware of, or have been following, the sailing permit requirements. As noted in the proposal, the sailing permit is no longer necessary given that the IRS has other tools to help ensure tax compliance by departing foreign citizens.

Define control of the payment of wage

Employers are required to pay employment taxes and withhold income tax from wages paid to employees. Section 3401(d)(1) provides an exception if the person for whom the individual performs services does not have control of the payment of the wages, in which case the employer is the person having “control of the payment of such wages.” If the exception applies, the liability for employment taxes and income tax withholding shifts from the common law employer to the person in control of the payment of wages.

The Eleventh Circuit created a new test for determining who has control of the payment of wages and concluded that a contract between the professional employer organization (PEO) and its clients (the common law employers) could affect who controls the wage payments.

The administration’s proposal would amend section 3401(d)(1) to clarify the phrase “control of the payment of wages” so that a common law employer cannot avoid liability for employment taxes and income tax withholding except in limited circumstances. The proposal would be effective after December 31, 2023.

Modernize rules, including those for digital assets

Apply the wash sale rules to digital assets and address related party transactions

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 proposal is similar to previous proposals to expand the wash sales made as part of the "Build Back Better Act" and the FY 2024 budget proposals and Green Book, with some minor modifications.

The proposal would expand the scope of the wash sale rules to cover digital assets and provide regulatory authority to the Secretary to treat any security as defined by section 475(c)(2), or any commodity as defined by section 475(e)(2), or other assets traded on an established market, as subject to the wash sale rules as necessary to prevent abuse.

KPMG observation

The term "stock or securities" is not defined in section 1091 or the regulations thereunder. However, it has generally be interpreted to exclude foreign currency, commodities, commodities derivatives, and digital assets. Depending on how Treasury exercises its regulatory authority, the proposal could greatly expand the scope of the wash sale rules. The expansion of the scope of the wash sale rules would require systems updates for taxpayers and brokers.

The proposal would also implement related party loss disallowance rules. Specifically, in the case of any loss from a sale of assets subject to the wash sale rules and a purchase by a related party of the same or substantially identical assets within 30 days of the sale, the loss would be disallowed and deferred until the related party sells or otherwise disposes of the asset, provided that the taxpayer and a related party do not reacquire the asset within 30 days before or after that sale or disposition, or the parties cease to be related.

A related party would include members of a taxpayer's family and tax-favored accounts such as individual retirement accounts controlled by the taxpayer or the taxpayer's spouse. Two entities would be related to each other if one controlled the other, directly or indirectly, or both were under the common control of either a third entity or the taxpayer and one or more family members. An individual would be related to an entity if the entity is controlled, directly or indirectly, by the individual and the individual's family members. The Secretary would have authority to issue regulations expanding this definition as necessary to prevent abuse, to provide rules for transactions where a taxpayer sold assets at a loss and both the taxpayer and a related party acquired the same or substantially similar assets, and to coordinate the operation of the wash sale rules with other rules dealing with sales of loss property between related parties (sections 267 and 707).

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. 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.

The application of the wash sale rules across related parties would require adjustments to taxpayers' systems and processes for identifying wash sale transactions and close coordination between related parties.

The wash sale rules would be amended to address derivative financial instruments more comprehensively, including modifications to the basis rules to prevent abuse.

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 might address this question and other issues relating to derivative transactions.

Like current law, the proposal would provide require brokers reporting a customer's adjusted basis on a disposition of a digital asset or other asset subject to the wash sale rules to report the basis of the asset without regard to the wash sale rules unless the sale of the loss asset and the transaction causing the wash sale rules to apply occurs in the same account with respect to identical assets.

KPMG observation

Given the changes made by the related party rules, the divergence between broker reporting of wash sales and the substantive wash sale rules would increase. However, the proposal would also provide the Secretary with authority to require brokers to report such information as may be necessary or appropriate to implement the wash sale rules, and it is possible this authority would be used to better align broker reporting with the substantive rules.

The proposal would provide the Secretary with regulatory authority to define the term "substantially identical," to provide an exception to the application of the wash sale rules for de minimis losses, and to provide an exception to the wash sale rules for ordinary course (non-trading) business transactions involving digital assets.

KPMG observation

Some guidance on the meaning of the term "substantially identical" can be found under the short sale transaction regulations, which use a similar standard. However, the term is notoriously difficult to interpret and additional guidance would be welcome.

Unlike previous proposals, this proposal would provide regulatory authority to implement exceptions for de minimis losses and ordinary course business transactions. This may reflect the growing acceptance of digital assets as a means of payment and the need to exclude those transactions from the wash sale rules as a matter of policy.

The proposal would be effective for tax years beginning after December 31, 2024.

Modernize rules treating loans of securities as tax-free to include other asset classes and address income inclusion

A common transaction in the securities market is a loan of securities. Owners of securities such as pension plans, mutual funds, insurance companies, and other institutional investors lend their securities because they receive compensation for doing so. Under current law, loans of securities of this kind ordinarily are treated as transactions in which no gain or loss is recognized if the transfer of a security is pursuant to an agreement that meets certain requirements under section 1058. Gain or loss also is not recognized on the return of that security in exchange for rights under the agreement. For this purpose, the term "securities" means corporate stock, notes, bonds, debentures and other evidence of indebtedness, and any evidence of an interest in or right to purchase any of the foregoing. However, the market for lending of financial and other assets has expanded over time to include new types of assets, and current law also does not address how a lender of a security that accrues interest (or other income) should take that interest (or other income) into account.

The proposal would expand the securities loan nonrecognition rules to include loans of actively traded digital assets recorded on cryptographically secured distributed ledgers, if such loans have terms similar to those currently required for loans of securities. For example, if during the term of a loan the owner of the digital asset would have received other digital assets or other amounts if the loan had not taken place, the terms of the loan agreement should provide that those amounts will be transferred by the borrower to the lender. Additionally, the proposal would require that income that would be considered by the lender if the lender had continued to hold the loaned asset must be taken into account by the lender in a manner that clearly reflects income. The proposal would provide for appropriate basis adjustments to the loan contract and when the loaned asset is returned. The proposal would clarify that fixed-term loans are subject to the securities loan nonrecognition rules if they would otherwise qualify.

The proposal would be effective for tax years beginning after December 31, 2024.

Provide for information reporting by certain financial institutions and digital asset brokers for purposes of exchange of information

Under current law, any person doing business as a broker is required to report certain information about its customers to the IRS, such as the identity of each customer, the gross proceeds from sales of securities and certain commodities for such customer, and, for covered securities, cost basis information. However, these rules do not adequately address transactions in digital assets, potentially permitting tax evasion. In addition, under current law, the United States may receive, as well as provide, tax information pursuant to an income tax treaty or other international information exchange agreement, including information about the identity of beneficial owners of entities. Such information is central to IRS enforcement efforts against offshore tax evasion. To ensure that the United States can benefit from a global automatic exchange of information framework with respect to offshore digital assets, the proposal would:

- Require certain financial institutions to report the account balance for all financial accounts maintained at a U.S. office and held by foreign persons
- 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

- Require financial institutions to report the gross proceeds from the sale or redemption of property held in, or with respect to, a financial account held by a foreign person

- Require financial institutions to report information regarding certain passive entities and their substantial foreign owners

When reporting with respect to digital assets held by passive entities, the proposal would:

- Require brokers to report information relating to the substantial foreign owners of the passive entities

- Require a broker to report gross proceeds and such other information as the Secretary may require with respect to sales of digital assets with respect to customers, and in the case of certain passive entities, their substantial foreign owners

The proposal would be effective for returns required to be filed after December 31, 2026.

Require reporting by certain taxpayers of foreign digital asset accounts

Section 6038D requires any individual that holds an interest in one or more specified foreign financial assets with an aggregate value of at least $50,000 during a tax year to attach a statement with required information to the individual's tax return by the due date for that return. Treasury regulations under section 6038D also apply the requirements of this section to domestic entities formed or availed of for the purpose of holding specified foreign financial assets. Currently, there are two general categories of specified foreign financial assets: (a) a financial account maintained by a foreign financial institution, and (b) certain specified foreign assets not held in a financial account maintained by such a financial institution. Information required to be reported includes the name and address of the financial institution where an account is maintained, the account number, as well as identifying information about assets not held in a financial account. The current rules, however, do not adequately address digital assets, and tax compliance and enforcement with respect to digital assets is a growing problem. This is especially true for individuals with offshore holdings of accounts with digital assets.

The proposal would amend section 6038D(b) to require reporting with respect to any account that holds digital assets maintained by a foreign digital asset exchange or other foreign digital asset service provider (a "foreign digital asset account"). Reporting will generally be required only for taxpayers that hold an aggregate value of all three categories of assets in excess of $50,000. A foreign digital asset account would generally be defined based on where the exchange or service provider is organized or established.

The proposal would be effective for returns required to be filed after December 31, 2024.

Amend the mark-to-market rules to include digital assets

Section 475 requires dealers in securities to use the mark-to-market method of accounting for inventory and non-inventory securities held at year end. For this purpose, a "security" includes corporate stock, interests in widely-held or publicly-traded partnerships and trusts, debt instruments, and certain derivative financial instruments. Dealers in commodities and traders in securities or commodities may elect to use the mark-to-market method. A "commodity" means any commodity that is actively traded, any notional principal contract with respect to any such commodity, and certain other derivative financial instruments and hedges with respect to such commodities. Mark-to-market accounting generally provides a clear reflection of income with respect to assets that are traded in established markets, and for financial accounting purposes, taxpayers may be required to mark inventory or trading positions to market, including at year-end. In addition, allowing taxpayers to use their financial accounting valuations for tax purposes may reduce tax compliance costs. However, the current mark-to-market rules do not include digital assets, many of which are actively traded.

The proposal would permit certain digital assets to be marked-to-market at the election of a dealer or trader in those assets—in particular, actively traded digital assets and derivatives on, or hedges of, those digital assets, under rules like those that apply to actively traded commodities. The determination of whether a digital asset is actively traded would consider relevant facts and circumstances, which may include whether the asset is regularly bought and sold for U.S. dollars or other fiat currencies, the volume of trading of the asset on exchanges that have reliable valuations, and the availability of reliable price quotations. A digital asset would not be treated as a security or commodity for purposes of the mark-to-market rules and would therefore be eligible for mark-to-market treatment only under the rules applicable to this new category of assets.

The proposal would be effective for tax years beginning after December 31, 2024.

Improve benefits tax administration

Rationalize funding for post-retirement medical and life insurance benefits

Currently, an employer can make deductible contributions to a welfare benefit fund, provided that the amount set aside does not exceed the account limit, which is generally the amount needed to fund specified welfare benefits for the current year. An exception to this limit allows an employer to accumulate an additional reserve for post-retirement medical and life insurance benefits. Under section 419A, this reserve must be "funded over the working lives of the covered employees and actuarially determined on a level basis."

The administration's proposal would not allow lump-sum funding but would require post-retirement benefits to be funded over the longer of the working lives of the covered employees on a level basis or 10 years unless the employer commits to maintain those benefits over a period of at least 10 years.

The proposal would be effective for tax years beginning after December 31, 2023.

Clarify tax treatment of on-demand pay arrangements

Employers withholding employment taxes (social security and Medicare taxes, unemployment tax, and income tax withholding) on wages. Wages include all remuneration for services performed by an employee for their employer. Employers withhold and pay employment taxes based on payroll periods, which can include daily, weekly, biweekly, semimonthly, etc.

Wages are considered paid when they are actually or constructively received by the employee, including when an amount is set apart or otherwise made available so that the employee may draw upon that amount at any time.

The administration's proposal would provide a definition of an on-demand pay arrangement as an arrangement that allows employees to withdraw earned wages before their regularly scheduled pay dates. The proposal would further provide that the payroll period for on-demand pay arrangements is treated as a weekly payroll period, even if employees have access to their wages during the week. Further, the proposal would clarify that on-demand pay arrangements are not loans for Federal tax purposes. The proposal would provide special payroll deposit rules for on-demand pay arrangements.

The proposal would be effective for calendar years and quarters beginning after December 31, 2023.

KPMG observation

Employers have been requesting guidance in the area of on demand pay arrangements. These arrangements are instituted to assist employees, but under current rules there can be burdensome administration and uncertainty.

Amend the excise tax on employment-based group health plans

Section 4980D imposes an excise tax on employers if their group health plans do not satisfy certain required standards. The administration's proposal would make a third-party administrator (TPA) liable for the excise tax instead of an employer if the TPA causes the employer's group health plan to be noncompliant with group health plan requirements. The proposal would be effective for tax years beginning after December 31, 2024.

Extend IRS funding

Extend mandatory funding provided to the IRS through fiscal year 2034

The IRA provided nearly $80 billion in mandatory funding to the IRS, over a 10-year period, ending with fiscal year 2031, to supplement the agency's annual appropriations. The Fiscal Responsibility Act of 2023 rescinded approximately $1.4 billion of that funding. The adjusted baseline for the fiscal year 2025 Budget reflects an additional $20.2 billion rescission of the IRA funding, consistent with the recently announced fiscal year 2024 topline budget agreement.

The mandatory funding provided by the IRA is divided across the IRS's core areas of activity: Taxpayer Services, Enforcement, Operations Support, and Business Systems Modernization. Incorporating the effect of the $20.2 billion rescission, the IRA funding for Enforcement will be exhausted in 2029 and the funding for Operations Support will be exhausted in 2030. Funds allocated for Taxpayer Services and Business Systems Modernization will be depleted much sooner, by 2026.

Before the enactment of the IRA, the IRS's operating budget fell by 18% in inflation-adjusted dollars between 2010 and 2021. Treasury and the IRS have made repeated public statements that IRA funding will be used to dramatically improve customer service, modernize decades-old computer systems, and improve enforcement with respect to complex partnerships, large corporations, and high-income individuals, all in the goal of ensuring a fairer and more efficient tax system and reducing the tax gap, which according to the Green Book is projected to be $688 billion in tax year 2021.

The Green Book highlights some tangible benefits that have resulted from the IRA funding, including shortened phone wait times, reopening of Taxpayer Assistance Centers, and a paperless processing initiative. The Green Book also notes the IRS compliance efforts regarding large foreign corporations, the expansion of its Large Corporate Compliance program, the leveraging of artificial intelligence to ramp up audits of large partnerships, and the collection of over half a billion dollars from individual taxpayers with more than $1 million in income who were seriously delinquent on their tax debt.

In the Green Book, Treasury further explains that long-term funding is essential for planning, especially to hire and train top talent to take on the most complex tax administration tasks, such as audits of complex partnerships and large corporations. According to Treasury, the IRS will be confronted with an abrupt and severe decline in its budget in fiscal year 2030, and the IRS will be forced to cut back on audits of large corporations and complex partnerships and thereby increase the deficit.

The proposal would provide mandatory funding for the IRS to supplement complement the annual discretionary appropriations for the agency's Taxpayer Services and Business Systems Modernization accounts for fiscal years 2026-2034, and the Technology and Operations Support account and the Enforcement account for fiscal years 2029-2034. The proposal would provide a total of $104.3 billion to sustain the improvements in taxpayer service, transform information technology, and enhance enforcement on high-income taxpayers, large corporations, and complex partnerships funded through the IRA. The following table provides the funding details.

PROPOSED MANDATORY FUNDING FOR THE IRS ($ BILLION)

Fiscal Year	2026	2027	2028	2029	2030	2031	2032	2033	2034	2025-2034
Taxpayer Services	1.7	1.9	1.9	1.9	2.0	2.0	2.1	2.1	2.1	17.7
Enforcement				1.3	9.6	11.7	11.9	12.1	12.4	58.9
Tech & Op Supt[1]				0.2	2.9	4.8	5.2	5.3	5.3	23.8
BSM[2]	1.0	0.9	0.3	0.3	0.3	0.3	0.3	0.3	0.3	3.9
Total	2.7	2.8	2.2	3.7	14.7	18.8	19.5	19.8	20.1	104.3

[1] Technology and Operations Support (abbreviated "Tech & Op Supt") includes costs for activities previously charged to the Operations Support account, including costs for supporting the proposed enforcement functions. [2]
[2] Business Systems Modernization (abbreviated "BSM") includes costs to complete technology transformation begun with IRA funding.

KPMG observation

Highlighting the fact that the IRS's operating budget fell by 18% in inflation-adjusted dollars between 2010 and 2021 (despite taxpayer growth and additional administrative obligations placed upon IRS during this period), the Green Book sets out the anticipated "transformational" change slated for the IRS over the next decade due to the IRA funding. General consensus exists in the broader tax community that the IRS has been challenged in recent years, encumbered by decreasing funding, reduced staffing, antiquated technology, and COVID-19. at the same time, it has been tasked withimplementing the TCJA, the CARES Act, the IRA and numerous other legislative changes. While the administration seeks to ensure mandatory IRS funding for future fiscal years, Congress will undoubtedly be closely watching how the IRS utilizes the funding and if the IRS achieves the transformational change outlined.

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