
General Explanations
of the
Administration's Fiscal Year 2023
Revenue Proposals



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The revenue proposals are estimated relative to a baseline that incorporates all revenue provisions of Title XIII of H.R. 5376 (as passed by the House of Representatives on November 19, 2021), except Sec. 137601.

The Administration’s proposals are not intended to create any inferences regarding current law.

Within the *General Explanations of the Administration’s Fiscal Year 2023 Revenue Proposals*, unless otherwise stated:

- “AGI” refers to Adjusted Gross Income
- “Budget” refers to the *Fiscal Year 2023 Budget of the U.S. Government*
- “Code” refers to the Internal Revenue Code
- “C-CPI-U” refers to the Chained Consumer Price Index for Urban Consumers
- “IRA” refers to Individual Retirement Account or Annuity
- “IRS” refers to the Internal Revenue Service
- “Section” refers to the respective section of the Internal Revenue Code
- “Secretary” refers to the Secretary of the Treasury
- “Treasury” refers to the Department of the Treasury
- “TIN” refers to Taxpayer Identification Number

REVENUE PROPOSALS

In the Administration's Fiscal Year 2023 Budget, the President proposes a number of reforms that would enhance revenues, improve tax administration, and make the tax system more equitable and efficient.

The Budget includes proposals that reform corporate taxation, encourage housing and urban development, strengthen the taxation of high-income taxpayers, support families and students, close loopholes, and improve tax administration and compliance.

Reforms to business and international taxation would collect sufficient revenue, build a fairer tax system, and reduce tax incentives that encourage profit shifting and offshoring. The Administration's proposals would also eliminate all fossil fuel subsidies.

Substantial revenues come from strengthening the taxation of high-income taxpayers. Income tax rates for those with the highest incomes would increase. Reformed taxation of capital income would even the tax treatment of labor and capital income and eliminate a loophole that lets some capital gains income escape income taxation forever. For extremely wealthy taxpayers, a minimum income tax would require prepayment of taxes on unrealized capital gains, such that liquid taxpayers are taxed at a rate of at least 20 percent on their income including unrealized capital gains. Similarly, several loopholes used by high-income taxpayers to avoid income, estate, and gift taxation would be closed, including the carried interest preference and the like-kind exchange real estate preference, which would be eliminated for those with the highest incomes.

Finally, the Budget includes many proposals that would improve, modernize, and simplify tax administration. These include proposals that revise tax rules to include digital assets, proposals that improve the tax administration of employee benefits, and proposals that help the IRS address common tax administration issues.

REFORM BUSINESS AND INTERNATIONAL TAXATION

RAISE THE CORPORATE INCOME TAX RATE TO 28 PERCENT

Current Law

Income of a business entity can be subject to Federal income tax in a manner that varies depending upon the classification of the entity for Federal income tax purposes. Most small businesses are owned by individuals and taxed as “pass-through” entities, meaning that their income is passed through to their owners who are taxed under the individual income tax system. Most large businesses, including substantially all publicly traded businesses, are classified as “C corporations” because these corporations are subject to the rules of subchapter C of chapter 1 of the Internal Revenue Code (Code), and accordingly pay an entity-level income tax. Additionally, taxable shareholders of such corporations generally pay Federal income tax on most distributions attributable to their ownership in the corporation. Some mid-sized businesses choose a pass-through form of entity classification (under subchapter K or subchapter S of chapter 1 of the Code) while others choose the C corporation form of entity classification.

C corporations determine their taxable income, credits, and tax liability according to the Code and regulations promulgated thereunder. The Tax Cuts and Jobs Act of 2017 replaced a graduated tax schedule (with most corporate income taxed at a marginal and average rate of 35 percent) with a flat tax of 21 percent applied to all C corporations.

Reasons for Change

Raising the corporate income tax rate is an administratively simple way to raise revenue to pay for the Administration’s infrastructure proposals and other longstanding fiscal priorities. A corporate tax rate increase can expand the progressivity of the tax system and help reduce income inequality. Additionally, a significant share of the effects of the corporate tax increase would be borne by foreign investors. Therefore, some of the revenue raised by this proposal would result in no additional Federal income tax burden on U.S. persons. Also, the majority of income from capital investments in domestic C corporations is untaxed by the U.S. government at the shareholder level, so the corporate tax is a primary mechanism for taxing such capital income.

Furthermore, many multinational corporations pay effective tax rates that are far below the statutory rate, due in part to low-taxed foreign income. The proposal would keep the global intangible low-taxed income (GILTI) deduction constant, raising the GILTI rate in proportion to the increase in the corporate rate. This avoids increasing the incentive to shift profits and activity offshore as the domestic rate is increased.

Proposal

The proposal would increase the tax rate for C corporations from 21 percent to 28 percent.

The 28 percent corporate income tax rate will consequently increase the GILTI rate in tandem. The proposal is scored under the assumption of a Build Back Better Act baseline. Therefore, the new GILTI effective rate would be 20 percent, applied on a jurisdiction-by-jurisdiction basis.

The proposal would be effective for taxable years beginning after December 31, 2022. For taxable years beginning before January 1, 2023, and ending after December 31, 2022, the corporate income tax rate would be equal to 21 percent plus 7 percent times the portion of the taxable year that occurs in 2023.

ADOPT THE UNDERTAXED PROFITS RULE

Current Law

Section 59A of the Internal Revenue Code (Code) imposes a Base Erosion Anti-Abuse Tax (BEAT) liability on certain corporate taxpayers, in addition to their regular tax liability. Liability for BEAT is generally limited to corporate taxpayers with substantial gross receipts that make deductible payments to foreign related parties above a specified threshold (referred to as a “base erosion payment”). Taxpayers potentially liable for this additional tax have three-year average gross receipts in excess of \$500 million and a “base erosion percentage” exceeding a specified threshold. The base erosion percentage is generally determined by dividing the taxpayer’s “base erosion tax benefits” by the amount of all deductions allowed to the taxpayer for the taxable year.¹

A taxpayer’s BEAT liability is computed by reference to the taxpayer’s “modified taxable income” and comparing the resulting amount to the taxpayer’s regular tax liability. For purposes of this calculation, regular tax liability is reduced by some but not all credits. For taxable years beginning after December 31, 2025, regular tax liability is reduced by all credits for this purpose. A taxpayer’s modified taxable income is equal to its regular taxable income increased by base erosion tax benefits with respect to base erosion payments and an adjustment for the taxpayer’s net operating loss (NOL) deduction, if any. The taxpayer’s BEAT liability generally equals the difference, if any, between 10 percent of the taxpayer’s modified taxable income and the taxpayer’s regular tax liability (as reduced by certain credits against such tax). For taxable years beginning after December 31, 2025, the relevant BEAT rate increases to 12.5 percent.²

Adjusted Baseline

Under the Build Back Better Act (BBBA), the definition of base erosion payments is revised in several ways. The definition is expanded with respect to inventory costs to include payments to a foreign related party for certain direct and indirect inventory costs. The BBBA also adds exceptions for payments where tax is imposed with respect to the payment under chapter 1 of the Code or payments subject to foreign income tax at a rate that is not less than the lesser of 15 percent or the BEAT tax rate for the taxable year.

The BBBA also modifies the manner in which NOLs are taken into account and other aspects of computing modified taxable income and, for taxable years beginning after December 31, 2023, eliminates the base erosion percentage threshold requirement for application of the BEAT.

Under the BBBA, the calculation of the BEAT liability changes in two ways. First, the taxpayer’s BEAT liability is computed by reference to the taxpayer’s regular tax liability without reduction by any tax credits, which has the effect of permitting the tax benefit of these credits for

¹ Under current Treasury regulations, taxpayers can avoid a BEAT liability by electing to “waive” enough deductions for payments made to related foreign persons sufficient to remain below the base erosion percentage threshold.

² For all periods, the relevant BEAT rate is one percentage point higher for certain banks and registered securities dealers.

purposes of the BEAT. Second, the BEAT tax rate increases each year through 2024 as described in the table below.

**ANNUAL BEAT TAX RATES UNDER THE BUILD BACK BETTER ACT
AND THE ADJUSTED BASELINE**

FOR TAXABLE YEARS		BEAT RATE
BEGINNING AFTER	AND BEFORE	(PERCENT)
December 31, 2021	January 1, 2023	10
December 31, 2022	January 1, 2024	12.5
December 31, 2023	January 1, 2025	15
December 31, 2024		18

Reasons for Change

The adjusted baseline reforms BEAT in several ways. The higher tax rate and expanded base would reduce the incentive for foreign-based multinational companies to shift profits offshore and encourage adoption of the global minimum tax. The exception for payments subject to sufficient tax would focus BEAT on payments to low-tax jurisdictions. However, since the recent legislative proposals for BEAT reform, there have been developments in the OECD international tax negotiations that provide another model for enforcing the new international tax agreement in coordination with the rest of the world.

On October 8, 2021, the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting reached a comprehensive agreement on minimum taxation under Pillar Two, and on December 20, 2021, it published Model Rules describing two interlocking Pillar Two rules: (a) an Income Inclusion Rule (IIR), which imposes top-up tax on a parent entity with respect to the low-taxed income of a member of its financial reporting group; and (b) an Undertaxed Profits Rule (UTPR), which denies deductions or requires an equivalent adjustment to tax liability to the extent that the low-taxed income of a member of the group is not subject to an IIR.³ The Pillar Two agreement provides for the IIR to be implemented in 2023 and the UTPR to be implemented in 2024.

In conjunction with the global intangible low-taxed income (GILTI) regime, adopting the UTPR ensures that income earned by a multinational company, whether based in the United States or elsewhere, is subject to a minimum rate of taxation regardless of where the income is earned. Just as GILTI (under the BBBA baseline assumptions) ensures that a minimum per-jurisdiction rate of tax is paid by U.S.-based multinationals on income earned through controlled foreign corporations (CFCs), the UTPR ensures that a minimum per-jurisdiction rate of tax is paid on

³ See <https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf> and <https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.pdf>.

income earned in each jurisdiction in which foreign-based multinationals operate. This ensures that companies cannot avoid a minimum rate of taxation by, for example, relocating their headquarters to a foreign jurisdiction that has not implemented an IIR. The UTPR is designed to encourage countries to adopt the global minimum tax agreed to as part of the international negotiations by ensuring that profits in low-tax jurisdictions are taxed at the same minimum rate.

This proposal would increase alignment between the U.S. international tax rules and the international system emerging from Pillar Two. In addition, Treasury has determined that the BEAT could be further strengthened to address the concern of erosion of the U.S. corporate tax base. For example, the BEAT does not apply comprehensively to cost of goods sold, or COGS, of manufacturing companies in the same manner that it applies to deductions incurred by services firms. In the addition, firms with lower profit margins are more likely to have a BEAT liability than similarly situated firms with higher profit margins because the BEAT is a form of alternative minimum tax.

Proposal

The proposal would repeal the BEAT and replace it with a UTPR that is consistent with the UTPR described in the Pillar Two Model Rules. When another jurisdiction adopts a UTPR, the proposal also includes a domestic minimum top-up tax that would protect U.S. revenues from the imposition of UTPR by other countries. Separately, the proposal would provide a mechanism to ensure U.S. taxpayers would continue to benefit from U.S. tax credits and other tax incentives that promote U.S. jobs and investment.

The UTPR would primarily apply to foreign-parented multinationals operating in low-tax jurisdictions. In addition, UTPR would apply only to financial reporting groups that have global annual revenue of \$850 million or more in at least two of the prior four years.

Under the UTPR, both domestic corporations that are part of a foreign-parented multinational group and domestic branches of foreign corporations would be disallowed U.S. tax deductions in an amount determined by reference to low-taxed income of foreign entities and foreign branches that are members of the same financial reporting group (including the common parent of the financial reporting group).⁴ Specifically, domestic group members would be disallowed U.S. tax deductions to the extent necessary to collect the hypothetical amount of top-up tax required for the financial reporting group to pay an effective tax rate of at least 15 percent in each foreign jurisdiction in which the group has profits.⁵ The amount of this top-up tax would be determined

⁴ A financial reporting group is any group of business entities that prepares consolidated financial statements and that includes at least one domestic entity or domestic branch and at least one foreign entity or foreign branch. Consolidated financial statements means those determined in accordance with U.S. Generally Accepted Accounting Principles (GAAP), International Financial Reporting Standards (IFRS), or other methods authorized by the Secretary under regulations. Under the proposal, the Secretary would be delegated authority to treat a group of business entities as a financial reporting group if a financial reporting group would exist had those business entities been required to prepare consolidated financial statements.

⁵ For example, a group with \$1,000x of profits in a foreign jurisdiction with no corporate income tax would have a top-up tax amount of \$150x with respect to that jurisdiction. If the top-up tax were not collected under GILTI or an IIR implemented by a foreign jurisdiction, a domestic corporation or domestic branch that is a member of the group

based on a jurisdiction-by-jurisdiction computation of the group's profit and effective tax rate consistent with the Pillar Two Model Rules, which would take into account all income taxes, including the corporate alternative minimum tax. As discussed below, the top-up amount would be allocated among all of the jurisdictions where the financial reporting group operates that have adopted a UTPR consistent with the Pillar Two Model Rules (a Qualified UTPR).

The computation of profit and the effective tax rate for a jurisdiction is based on the group's consolidated financial statements, with certain specified adjustments such as rules to address temporary and permanent differences between the financial accounting and tax bases. In addition, the computation of a group's profit for a jurisdiction is reduced by an amount equal to 5 percent of the book value of tangible assets and payroll with respect to the jurisdiction.⁶

In addition to the general limitation of the UTPR to financial reporting groups that have global annual revenue of at least \$850 million, the proposal includes several de minimis exclusions. The UTPR would not apply to a group's profit in a jurisdiction if the three-year average of the group's revenue in the jurisdiction is less than \$11.5 million and the three-year average of the group's profit in the jurisdiction is less than \$1.15 million.⁷ Under an exception for groups in the initial phase of their international activity, the UTPR would not apply to a group with operations in no more than five jurisdictions outside of the group's primary jurisdiction and the book value of the group's tangible assets in those jurisdictions is less than \$57 million. This exception would expire five years after the first day of the first year in which the UTPR otherwise would apply to the group.

The deduction disallowance applies pro rata with respect to all otherwise allowable deductions,⁸ and applies after all other deduction disallowance provisions in the Code. To the extent that the UTPR disallowance for a taxable year exceeds the aggregate deductions otherwise allowable to the taxpayer for that year, such excess amount of the UTPR disallowance would be carried forward indefinitely until an equivalent amount of deductions are disallowed in future years.

A coordination rule would reduce the UTPR disallowance imposed by the United States to reflect any top-up tax collected by members of the group under a Qualified UTPR in one or more other jurisdictions. With respect to each financial reporting group, the percentage of top-up tax allocated to the United States would be determined by the following formula where a QTPR jurisdiction is a jurisdiction applying a qualified UTPR.

would be subject to a deduction disallowance of \$536x, equal to the top-up tax amount of \$150x divided by the U.S. corporate income tax rate of 28 percent. For simplicity, this example assumes that there are no tangible assets or payroll in the foreign jurisdiction with no corporate income tax, and that there are no other jurisdictions with a UTPR such that all of the top-up tax is allocated to the domestic corporation or domestic branch.

⁶ During a transition period of nine years, the exclusion equals 7.8 percent of the book value of tangible assets and 9.8 percent of payroll, declining annually by 0.2 percentage points for the first four years, by 0.4 percentage points for tangible assets and by 0.8 percentage points for payroll for the last five years.

⁷ Under the proposal, the Secretary would be delegated authority to adjust dollar-based thresholds to address currency fluctuations for international standards reflected in Euros.

⁸ For example, if a taxpayer incurs \$50x of interest expense that would otherwise be deductible and would otherwise be allowed a \$50x depreciation deduction, a UTPR disallowance of \$20x would disallow a deduction for \$10x of the interest expense and \$10x of the depreciation.

$$\begin{aligned}
 \text{US allocation} = & \\
 & 50\% \times \frac{\text{Number of employees in the U.S.}}{\text{Number of employees in all QUTPR jurisdictions}} \\
 & + \\
 & 50\% \times \frac{\text{Total book value of tangible assets in the U.S.}}{\text{Total book value of tangible assets in all QUTPR jurisdictions}}
 \end{aligned}$$

The portion of the top-up tax allocated to the United States would be allocated among domestic group members (domestic corporations and domestic branches) under regulations prescribed by the Secretary or her delegates (Secretary).

If any prior year's UTPR disallowance has not yet resulted in cash tax liability equal to the full amount of the prior year's allocated top-up tax (for instance, due to net operating losses) then, in general, no additional top-up tax for the current year would be allocated to the United States until the UTPR disallowance has resulted in a cash tax liability equal to the full amount of the allocated top-up tax. Any low-taxed profits of the group for the given year may instead be subject to a Qualified UTPR applied in other jurisdictions.

The UTPR would not apply with respect to income subject to an IIR that is consistent with the Pillar Two Model Rules, including income that is subject to GILTI. Thus, the UTPR would generally not apply to U.S.-parented multinationals. Whether a foreign jurisdiction has in effect a Qualified UTPR or an IIR that is consistent with the Pillar Two Model Rules would be determined by the Secretary under the standard specified in the Pillar Two Model Rules.

The proposal includes a domestic minimum top-up tax that would apply when another jurisdiction adopts the UTPR. This top-up tax equals the excess of (a) 15 percent of the financial reporting group's U.S. profit determined using the same rules as under the UTPR to determine the group's profit for a jurisdiction, over (b) all the group's income tax paid or accrued with respect to U.S. profits (including federal and state incomes taxes, corporate alternative minimum tax, and creditable foreign income taxes incurred with respect to U.S. profits). When another jurisdiction adopts the UTPR, the proposal would also ensure that taxpayers continue to benefit from tax credits and other tax incentives that promote U.S. jobs and investment.

The proposal to repeal the BEAT and replace it with the UTPR would be effective for taxable years beginning after December 31, 2023.

PROVIDE TAX INCENTIVES FOR LOCATING JOBS AND BUSINESS ACTIVITY IN THE UNITED STATES AND REMOVE TAX DEDUCTIONS FOR SHIPPING JOBS OVERSEAS

Current Law

Under current law, there are limited tax incentives for U.S. employers to bring offshore jobs and investments into the United States. In addition, costs incurred to offshore U.S. jobs generally are deductible for U.S. income tax purposes.

Reasons for Change

The Administration would like to create a tax incentive to bring offshore jobs and investments back into the United States. In addition, the Administration proposes to reduce the tax benefits that exist under current law for expenses incurred to move U.S. jobs offshore.

Proposal

The proposal would create a new general business credit equal to 10 percent of the eligible expenses paid or incurred in connection with onshoring a U.S. trade or business. For this purpose, onshoring a U.S. trade or business means reducing or eliminating a trade or business or line of business currently conducted outside the United States and starting up, expanding, or otherwise moving the same trade or business within the United States, to the extent that this action results in an increase in U.S. jobs. While the eligible expenses may be incurred by a foreign affiliate of the U.S. taxpayer, the tax credit would be claimed by the U.S. taxpayer. If a non-mirror code U.S. territory (the Commonwealth of Puerto Rico and American Samoa) implements a substantially similar proposal, the U.S. Treasury will reimburse the U.S. territory for the new general business credits provided to their taxpayers pursuant to a plan. Furthermore, the U.S. Treasury will reimburse a mirror code U.S. territory (Guam, the Commonwealth of the Northern Mariana Islands, and the U.S. Virgin Islands) for the new general business credits provided to their taxpayers by reason of the enactment of the proposal.

In addition, to reduce tax benefits associated with U.S. companies moving jobs outside of the United States, the proposal would disallow deductions for expenses paid or incurred in connection with offshoring a U.S. trade or business. For this purpose, offshoring a U.S. trade or business means reducing or eliminating a trade or business or line of business currently conducted inside the United States and starting up, expanding, or otherwise moving the same trade or business outside the United States, to the extent that this action results in a loss of U.S. jobs. In addition, 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.

For purposes of the proposal, expenses paid or incurred in connection with onshoring or offshoring a U.S. trade or business are limited solely to expenses associated with the relocation of the trade or business and do not include capital expenditures or costs for severance pay and other assistance to displaced workers. The Secretary or her delegates may prescribe rules to

implement the provision, including rules to determine covered expenses and treatment of independent contractors.

The proposal would be effective for expenses paid or incurred after the date of enactment.

PREVENT BASIS SHIFTING BY RELATED PARTIES THROUGH PARTNERSHIPS

Current Law

A partnership is permitted to make a section 754 election to adjust the basis of its property when it makes certain distributions of money or property to a partner. For example, if a partnership distributes property to a partner and the partnership has a section 754 election in effect, the partnership may increase (“step-up”) the basis of its non-distributed property. Any partnership step-up is generally equal to (a) the amount of any gain recognized by the distributee-partner and (b) in certain cases, the excess of the partnership’s basis, over the distributee-partner’s basis, in the distributed property.

Reasons for Change

Under current law, related-party partners may use a section 754 election to shift basis between partners and achieve an immediate tax savings for the partners as a group without any meaningful change in the partners’ economic arrangement.

More specifically, in 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, resulting in immediate increases in depreciation or amortization deductions for remaining partners related to the distributee-partner. For example, when a partnership distributes property to a partner, the distributee-partner may take a basis in the distributed property that is less than that of the distributing partnership, resulting in a decrease (“step-down”) in the basis of the distributed property in the hands of the distributee-partner. In such a situation, the distributing partnership is allowed to step-up the basis of its non-distributed property by an amount equal to the distributee-partner’s step-down in the basis of its distributed property. If the distributed property is held by the distributee-partner indefinitely, the basis step-down does not create taxable income for the distributee-partner, while the basis step-up to the distributing partnership’s depreciable or amortizable property could result in remaining partners related to the distributee-partner immediately benefiting from increased amounts of allocable deductions for depreciation or amortization.

Proposal

The proposal would reduce the ability of related parties to use a partnership to shift partnership basis among themselves. In the case of a distribution of partnership property that results in a step-up of the basis of the partnership’s non-distributed property, the proposal would apply a matching rule that would prohibit any partner in the distributing partnership that is related to the distributee-partner from benefitting from the partnership’s basis step-up until the distributee-partner disposes of the distributed property in a fully taxable transaction.

The Secretary and her delegates would have the authority to prescribe regulations necessary to implement the matching rule with respect to related parties.

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

CONFORM DEFINITION OF “CONTROL” WITH CORPORATE AFFILIATION TEST

Current Law

Most large businesses in the United States are comprised of corporate affiliates connected to the parent company through direct and indirect links of stock ownership. In order to administer the income tax to these corporate groups in a manner that reflects economic substance and prevents abuse, the Internal Revenue Code (Code) must define what it means for one corporation to “control” another.

For purposes of most corporate tax provisions, “control,” as defined by section 368(c) of the Code, requires ownership of stock possessing at least 80 percent of the total combined voting power of all classes of voting stock and at least 80 percent ownership of the total number of shares of each class of outstanding nonvoting stock of the corporation. For the purpose of determining whether a corporation is a member of an “affiliated group” of corporations under section 1504(a)(1) of the Code, the “affiliation” test is significantly different. Specifically, the test under section 1504(a)(2) requires ownership of stock possessing at least 80 percent of the total voting power of the stock of the corporation and that has a value of at least 80 percent of the total value of the stock of the corporation.

Reasons for Change

The control test under section 368(c) creates potential for taxpayers to improperly achieve desired tax outcomes through structured transactions. By carefully allocating voting power among the shares of a corporation, taxpayers can manipulate the section 368(c) control test in order to qualify or not qualify, as desired, a transaction as tax-free. 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. A uniform ownership test for corporate transactions would reduce the complexity currently caused by these inconsistent tests.

Proposal

The proposal would conform the control test under section 368(c) with the affiliation test under section 1504(a)(2). Therefore, “control” would be defined as the ownership of at least 80 percent of the total voting power and at least 80 percent of the total value of stock of a corporation.

The proposal would be effective for transactions occurring after December 31, 2022.

EXPAND ACCESS TO RETROACTIVE QUALIFIED ELECTING FUND ELECTIONS

Current Law

The passive foreign investment company (PFIC) rules are intended to prevent taxpayers from deferring the taxation of income from passive investments and from transforming the character of income from those investments from ordinary income into capital gain by holding the investments through a foreign investment company. Absent a qualified electing fund (QEF) or another permitted election, excess distributions received from a PFIC are subject to additional tax in an amount determined by reference to the rate of interest that applies to underpayments of tax. Gain recognized on disposition of PFIC stock is treated as an excess distribution.

If an investor in a PFIC makes a QEF election, the taxpayer is not subject to the tax on excess distributions after the effective date of the election. Instead, the taxpayer generally is required to take into account the taxpayer's pro rata share of the ordinary income and long-term capital gain of the PFIC on an annual basis and pay tax on this income. Section 1295(b)(2) of the Internal Revenue Code generally allows the owner of a PFIC to make a QEF election for any taxable year at any time on or before the due date for filing the return of the tax. Section 1295(b)(2) permits an election to be made after that date if the taxpayer reasonably believed that the company was not a PFIC, to the extent provided by regulations.

Under regulations, a taxpayer also is permitted to make a retroactive QEF election if the Commissioner of Internal Revenue consents to the election under a special consent procedure. In order to qualify for the special consent procedure, three conditions must be met: the taxpayer must have relied on a qualified tax professional, granting consent must not prejudice the interests of the U.S. government, and the request for the special consent must be made before the issue is raised on audit.

Reasons for Change

A taxpayer who makes a QEF election does not obtain the timing and character benefits that the PFIC rules are intended to prevent. QEF elections reduce tax costs to investors and increase tax compliance. The availability of a QEF election also incentivizes taxpayers to voluntarily report investments in a PFIC.

Under current law, individuals who inadvertently did not make a QEF election with respect to a PFIC investment may not be eligible for relief under the special consent procedure. For example, a student with low or no income may inherit stock and discover only years later that the stock is that of a PFIC when the individual hires a qualified tax professional. In other cases, an individual may have hired a qualified tax professional who fails to advise the taxpayer of the availability of a QEF election but refuses to provide an affidavit acknowledging that failure.

Additionally, there are large individual and administrative costs under current law for the existing special consent procedure. The existing procedure requires a taxpayer to file a ruling request with the IRS and pay a user fee that is currently several thousand dollars. The IRS receives many requests for consent, which result in the use of IRS time and resources to

determine whether consent should be granted and, if so, to issue the private letter ruling. In many cases, allowing the taxpayer to make a retroactive QEF election would be consistent with the proper administration of the law and would promote tax compliance, but the IRS must deny the request because the taxpayer does not qualify for relief under the special consent procedure.

In order to encourage more taxpayers to make QEF elections, and to relieve the costs and burdens that current law imposes on both taxpayers and the IRS, retroactive QEF elections should be permitted in a broader range of fact patterns by changing the statute. The IRS should have authority to allow a retroactive QEF election after the first year of ownership of a PFIC in appropriate cases even if the taxpayer cannot demonstrate a reasonable belief that the company was not a PFIC and cannot satisfy the special consent requirements.

Proposal

The proposal would modify section 1295(b)(2) to permit a QEF election by the taxpayer at such time and in such manner as the Secretary or her delegates (Secretary) shall prescribe by regulations.

Taxpayers would be eligible to make a retroactive QEF election without requesting consent only in cases that do not prejudice the U.S. government. For example, if the taxpayer owned the PFIC in taxable years that are closed to assessment, the taxpayer would need to obtain consent and to pay an appropriate amount to compensate the government for the taxes not paid in the closed years on amounts that would have been includable in the taxpayer's income if the taxpayer had made a timely QEF election.

While it is less common for partnerships and other non-individual taxpayers to inadvertently fail to make a QEF election, the Secretary would have authority to allow such taxpayers to make retroactive QEF elections in appropriate circumstances.

The proposal would be effective on the date of enactment. It is intended that regulations or other guidance would permit taxpayers to amend previously filed returns for open years.

EXPAND THE DEFINITION OF FOREIGN BUSINESS ENTITY TO INCLUDE TAXABLE UNITS

Current Law

In general, section 6038 of the Internal Revenue Code (Code) requires a U.S. person who controls a foreign business entity (a foreign corporation or foreign partnership) to report certain information with respect to such entity. The statute provides for penalties for a failure to report.

Adjusted Baseline

Modifications made to the international tax system by the Build Back Better Act (BBBA) require additional information reporting to enforce tax laws. In particular, the BBBA revises the global intangible low-taxed income (GILTI) regime, the Subpart F income regime, and the foreign tax credit (FTC) rules such that they apply on a jurisdiction-by-jurisdiction basis. To effectuate this jurisdiction-by-jurisdiction approach, the BBBA generally applies the GILTI, Subpart F, and FTC rules separately to all “taxable units” resident in a jurisdiction. In general, a taxable unit is any of (a) a taxpayer, (b) a foreign corporation in which the taxpayer is a U.S. shareholder, and (c) any pass-through entity or branch of the taxpayer or the foreign corporation if the pass-through entity or branch has a tax residence or taxable presence that is different than the tax residence of the taxpayer or the foreign corporation.

To illustrate, assume a taxpayer is a U.S. shareholder in a controlled foreign corporation (CFC) that is a tax resident of Country Y. Suppose the CFC conducts business in a branch with a taxable presence in Country Z, and the income of both the CFC and the Country Z branch give rise to tested income subject to the GILTI regime. Under current law, without regard to the BBBA, the taxpayer would not separate the income and foreign income taxes of the CFC and Country Z branch in applying the GILTI regime and FTC rules. However, under the BBBA, the taxpayer would apply the GILTI regime and the FTC rules separately to the income and foreign income taxes of the CFC (Country Y) and the Country Z branch, each of which is a taxable unit in a separate jurisdiction.

Reasons for Change

Because of the shift in emphasis to apply GILTI, Subpart F, and the FTC rules using a jurisdiction-by-jurisdiction taxable unit standard, there is a need to collect information at the same level; that is, collecting information with respect to each taxable unit in a foreign jurisdiction. By obtaining accurate information on each taxable unit, compliance and enforcement efforts would be improved. To further improve compliance, penalties for failure to provide information should also apply for reporting failures at the taxable unit level.

Proposal

The proposal would expand the definition of foreign business entity to treat any taxable unit in a foreign jurisdiction as a “foreign business entity” for purposes of applying section 6038. Thus,

information would be required to be reported separately with respect to each taxable unit, and penalties would apply separately for failures to report with respect to each taxable unit.

To harmonize the reporting with the annual accounting period for which taxable income of a branch or disregarded entity is determined, the proposal would also provide that, except as otherwise provided by the Secretary or her delegates (Secretary), the annual accounting period for a taxable unit that is a branch or disregarded entity is the annual accounting period of its owner. For example, if a domestic corporation or a CFC conducts activities in a foreign branch or owns a foreign disregarded entity, the annual accounting period of the foreign branch or foreign disregarded entity generally would be the annual accounting period of the domestic corporation or CFC, respectively.

Finally, for a taxpayer who is a U.S. person (as defined in section 7701(a)(30) of the Code) but who is resident of a foreign jurisdiction, the proposal would provide the Secretary with the authority to treat the taxpayer as a resident of the United States for the purpose of identifying a taxable unit subject to reporting under section 6038.

The proposal would apply to taxable years of a controlling U.S. person that begin after December 31, 2022, and to annual accounting periods of foreign business entities that end with or are within such taxable years of the controlling U.S. person.

SUPPORT HOUSING AND URBAN DEVELOPMENT

MAKE PERMANENT THE NEW MARKETS TAX CREDIT

Current Law

The New Markets Tax Credit (NMTC) is an up-to-39 percent credit for qualified equity investments (QEIs) made to acquire stock in a corporation, or a capital interest in a partnership, that is a qualified community development entity (CDE). The investment must be held for a period of at least seven years and must have been made within five years after the CDE receives an allocation out of the national credit limitation amount for the year. The CDEs in turn are required to invest substantially all of the proceeds of the QEIs in low-income communities. For example, CDEs may make loans or capital investments in companies that operate in low-income communities.

In order for an entity to qualify as a CDE, it must meet three requirements. First, the primary mission of the entity must be to serve or provide investment capital for low-income communities or low-income persons. Second, the entity must maintain accountability to residents of low-income communities through their representation on the entity's governing or advisory board. Third, the entity must be certified as a CDE by the Treasury Department's Community Development Financial Institutions Fund (CDFI Fund).

For calendar years 2010 through 2019, the national credit limitation amount per year was \$3.5 billion, and for 2020 through 2025 the annual amount is \$5 billion. No new investment allocation authority is provided beyond 2025. The CDFI Fund allocates credit amounts, subject to the total national credit limitation, among CDEs based on a competitive application process.

A taxpayer's allowable credit amount for any given year is the applicable percentage of the amount paid to the CDE for the investment at its original issue. Specifically, the applicable percentage is five percent for the year the equity interest is purchased from the CDE and for each of the two subsequent years, and it is six percent for each of the following four years. The NMTC is available for a taxable year to the taxpayer who holds the QEI on the date of the initial investment or on an investment anniversary date that occurs during the taxable year. The credit is recaptured if, at any time during the seven-year period that begins on the date of the original issue of the investment, either the entity ceases to be a qualified CDE, the proceeds of the investment cease to be used as required, or the equity investment is redeemed.

The NMTC can be used to offset regular Federal income tax liability but, if the taxpayer is not a corporation and has an alternative minimum tax (AMT) liability, the NMTC cannot be used to offset the AMT.

Reasons for Change

Permanent extension of the NMTC would allow CDEs to continue to generate investments in low-income communities. The extension would also create greater certainty for investment planning purposes.

Proposal

The proposal would extend the NMTC permanently, with a new allocation for each year after 2025. The annual amount would be \$5 billion, indexed for inflation after 2026.

The proposal would be effective after the date of enactment.

ALLOW SELECTIVE BASIS BOOSTS FOR BOND-FINANCED LOW-INCOME HOUSING CREDIT PROJECTS

Current Law

Federal income taxes may be offset by low-income housing tax credits (LIHTCs) that incentivize and subsidize the construction and rehabilitation of affordable rental housing for low-income tenants. One way a building can become eligible to earn LIHTCs is if the building and the land on which it sits are at least 50 percent financed with Qualified Private Activity Bonds (PABs) that are taken into account for purposes of the applicable “volume cap” – the annual limit that restricts the amount of PABs that each “State” may issue for all purposes. (In this context, all States, territories, and the District of Columbia are together referred to as “States.”) A PAB is a type of bond issued by a State or local government when more than 10 percent of the proceeds of the bond issue are used for private business use, and the bond issue is either secured by property used for a private business use or repaid from property used for a private business use. A PAB is a qualified bond, and therefore is tax exempt, if it is issued for certain purposes. Those purposes include financing qualified residential rental projects, which may be eligible to earn LIHTCs.

Subject to certain conditions, if a taxpayer owns such a PAB-financed LIHTC building, then, for each of 10 years, the taxpayer may claim tax credits equal to the product of three numbers: (a) the depreciable cost of the entire building (eligible basis); (b) the portion of the building dedicated to low-income units; and (c) a credit rate.⁹ To claim the credits, the owner must construct and operate the LIHTC building in compliance with applicable Federal law, including LIHTC limitations on tenant income, restrictions on gross rents, and minimum habitability requirements. Also, the credits must not exceed the amount the State or local housing credit agency (HCA) determines is necessary for fiscal feasibility.

Alternatively, a building can become eligible to earn LIHTCs if the relevant State or local HCA allocates potential credits to that building out of the State’s finite ceiling of potential credits. If a building becomes eligible to earn LIHTCs because of such an allocation, it must satisfy essentially the same criteria as a PAB-financed building. In the annual computation of credits earned, however, the credit rate is generally nine percent, and the LIHTCs claimed each year with respect to buildings that gain eligibility in this manner may not exceed the potential credits that the HCA initially allocated for the building.

The Internal Revenue Code allows a higher subsidy in some cases, notably for buildings in certain locations identified by the Department of Housing and Urban Development (HUD). The locations that HUD identifies must be characterized by low incomes or high poverty rates or must have high development costs relative to residents’ incomes.¹⁰ The higher subsidy is attained by computing LIHTCs based on 130 percent of actual depreciable basis (colloquially called a “basis boost”). In the case of buildings whose eligibility to earn LIHTCs derives from an HCA allocation of potential LIHTCs, the boost increases LIHTCs only to the extent that the HCA allocates sufficient additional potential credits to support the enhanced calculation.

⁹ In the current interest environment, the credit rate for a PAB-financed LIHTC building is four percent.

¹⁰ A location is considered low income if more than half of the households in that location have income less than 60 percent of the applicable area median gross income.

Regardless of location, if the HCA determines that a higher subsidy is necessary for the financial feasibility of an allocation-based building, the HCA may provide a basis boost as if it were in one of the basis-boost locations. These nongeographic boosts, however, are not available to PAB-financed LIHTC buildings.

Reasons for Change

Geographically grounded basis boosts have proved effective in significantly increasing the supply of affordable rental housing, which is in increasingly short supply across the nation. These basis boosts enable many proposed projects – both those with allocations of potential credits and those with PAB financing – to achieve financial feasibility. The statutory exclusion of PAB-financed projects from receiving nongeographic boosts, however, deprives communities of needed additional affordable rental housing, especially in high-opportunity areas.

Proposal

The proposal would, in certain cases, enable HCAs to give PAB-financed buildings nongeographic boosts, like the nongeographic boosts that HCAs can give under current law to buildings with allocations of potential credits. The HCA would provide the boost by designating a PAB-financed building as requiring an increase in credit to be financially feasible as part of a qualified low-income housing project. Regardless of where the designated building is located, it would receive a basis boost as if it were in a location that produces eligibility for such a boost. This nongeographic boost, however, would apply only to new construction or to a substantial rehabilitation that adds new net units.

The proposal would be effective for buildings that receive more than de minimis financing from certain PABs. These PABs must be part of a bond issue with an issue date after the date of enactment.

MODIFY FOSSIL FUEL TAXATION

ELIMINATE FOSSIL FUEL TAX PREFERENCES

Current Law

Current law provides several credits, deductions, and other special provisions that are targeted towards encouraging oil, gas, and coal production.

Credit for enhanced oil recovery

The general business credit includes a 15 percent credit for eligible costs attributable to enhanced oil recovery (EOR) projects. Eligible costs include the cost of constructing a gas treatment plant to prepare Alaskan natural gas for pipeline transportation, the cost of depreciable or amortizable tangible property that is integral to a qualified EOR project, intangible drilling and development costs (IDCs), and any allowable qualified tertiary injectant expenses that are paid or incurred in connection with a qualified EOR project. A qualified EOR project must be located in the United States and must involve the application of one or more of nine tertiary recovery methods. The allowable credit is phased out over a \$6 range for a taxable year if the annual reference price exceeds an inflation adjusted threshold.

Credit for oil and natural gas produced from marginal wells

In addition, the general business credit includes a credit for crude oil and natural gas produced from marginal wells. For taxable years beginning after 2005, the full potential credit rate is determined by the annual inflation adjustment applied to a starting credit rate of \$3.00 per barrel of oil and \$0.50 per 1,000 cubic feet of natural gas. The credit per well is limited to 1,095 barrels of oil or barrel-of-oil equivalents per year. The credit rates for crude oil and natural gas are phased out for a taxable year if the reference price exceeds the applicable thresholds. The crude oil phase-out range and the applicable threshold at which phase-out begins in 2020 are \$3.97 and \$19.87 respectively. The natural gas phase-out range and the applicable threshold at which phase-out begins are \$0.44 and \$2.21. Both sets of rates are adjusted annually for inflation. In 2020, the credit amount was the full rate of \$0.66 per 1,000 cubic feet of natural gas and the credit for oil was completely phased out.

Expensing of intangible drilling costs (IDCs)

IDCs include all expenditures made by an operator 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. An operator who pays or incurs IDCs in the development of an oil or natural gas property located in the United States, including certain wells drilled offshore, may elect either to expense or capitalize those costs. If a taxpayer elects to expense IDCs, the amount of the IDCs is deductible as an expense in

the taxable year the cost is paid or incurred. For any particular taxable year, a taxpayer may deduct some portion of its IDCs and capitalize the rest under the provision.

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

Taxpayers are allowed to deduct the cost of qualified tertiary injectant expenses for the taxable year. Qualified tertiary injectant expenses are amounts paid or incurred for any tertiary injectants, except for recoverable hydrocarbon injectants, that are used as a part of a tertiary recovery method to increase the recovery of crude oil. The deduction is treated as an amortization deduction in determining the amount subject to recapture upon disposition of the property.

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

Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be used against other income, such as wages, portfolio income, or business income that is derived from a nonpassive activity. A similar rule applies to credits. Passive activities are defined to include trade or business activities in which the taxpayer does not materially participate. An exception is provided, however, for any working interest in an oil or natural gas property that the taxpayer holds directly or through an entity that does not limit the liability of the taxpayer with respect to the interest. Suspended deductions and credits are carried forward and treated as deductions and credits from passive activities in the next year. The suspended losses and credits from a passive activity are allowed in full when the taxpayer completely disposes of the activity.

Use of percentage depletion with respect to oil and natural gas wells

The capital costs of oil and natural gas wells are recovered through the depletion deduction. Under the cost depletion method, the basis recovery for a taxable year is proportional to the exhaustion of the property during the year and cannot exceed basis. A taxpayer may also qualify for percentage depletion, under which the amount of the deduction is a statutory percentage of the gross income from the property. In general, only independent producers and royalty owners, in contrast to integrated oil companies, qualify for the percentage depletion deduction. A qualifying taxpayer determines the depletion deduction for each oil and natural gas property under both the percentage depletion method and the cost depletion method then deducts the larger of the two amounts. Because percentage depletion is computed without regard to the taxpayer's basis in the depletable property, a taxpayer may continue to claim percentage depletion after all the expenditures incurred to acquire and develop the property have been recovered.

Two-year amortization of independent producers' 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 amortization period for geological and geophysical expenditures incurred in connection with oil and natural gas exploration in the United States is two years for independent producers and seven years for major integrated oil companies.

Expensing of mine exploration and development costs

A taxpayer may elect to expense the exploration costs incurred for the purpose of ascertaining the existence, location, extent, or quality of a domestic ore or mineral deposit, including a deposit of coal or other hard mineral fossil fuel. After the existence of a commercially marketable deposit has been disclosed, costs incurred for the development of a mine to exploit the deposit are deductible in the year paid or incurred unless the taxpayer elects to deduct the costs on a ratable basis as the minerals or ores produced from the deposit are sold.

Percentage depletion for hard mineral fossil fuels

The capital costs of coal mines and other hard-mineral fossil-fuel properties are recovered through the depletion deduction. Under the cost depletion method, the basis recovery for a taxable year is proportional to the exhaustion of the property during the year. A taxpayer may also qualify for percentage depletion; hence, the amount of the deduction is a statutory percentage of the gross income from the property. A qualifying taxpayer determines the depletion deduction for each property under both the percentage depletion method and the cost depletion method and deducts the larger of the two amounts. Because percentage depletion is computed without regard to the taxpayer's basis in the depletable property, a taxpayer may continue to claim percentage depletion after all the expenditures incurred to acquire and develop the property have been recovered.

Treatment of capital gains for royalties

Royalties received on the disposition of coal or lignite generally qualify for treatment as long-term capital gain, and the royalty owner does not qualify for percentage depletion with respect to the coal or lignite. This treatment does not apply unless the taxpayer has been the owner of the mineral in place for at least one year before it is mined.

Exemption from the corporate income tax for fossil fuel publicly traded partnerships

Publicly traded partnerships are generally subject to the corporate income tax. Partnerships that derive at least 90 percent of their gross income from depletable natural resources, real estate, or commodities are exempt from the corporate income tax. Instead, they are taxed as partnerships. They pass through all income, gains, losses, deductions, and credits to their partners, with the partners then being liable for income tax (or benefitting from the losses) on their distributive shares.

Oil Spill Liability Trust Fund (OSTLF) excise tax exemption for crude oil derived from bitumen and kerogen-rich rock

Crudes such as those that are produced from bituminous deposits as well as kerogen-rich rock are not treated as crude oil or petroleum products for purposes of the OSTLF tax. They are exempt from the oil spill liability excise tax of \$0.09 per barrel of crude oil received at a United States refinery, and on petroleum products entered into the United States for consumption, use, or warehousing.

Amortization of air pollution control facilities

Under current law, a taxpayer may elect to amortize expenses related to certain pollution control facilities over 60 months or 84 months. The 60-month period applies to property placed in service at a plant that began operation prior to January 1, 1976. The 84-month period applies to property placed in service after April 11, 2005 and used in connection with an electric generation plant or other property which is primarily coal-fired and constructed after December 31, 1975. Eligible pollution control facilities include new identifiable treatment facilities that are used 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. Eligible facilities must be certified by a State certifying authority and a Federal certifying authority as being in compliance with applicable regulations and requirements. Without this special treatment, most pollution control facilities would be depreciated over 39 years as nonresidential real estate property.

Reasons for Change

These oil, gas, and coal tax preferences distort markets by encouraging more investment in the fossil fuel sector than would occur under a neutral system. This market distortion is detrimental to long-term energy security and is also inconsistent with the Administration's policy of supporting a clean energy economy, reducing our reliance on oil, and reducing greenhouse gas emissions.

Proposal

The proposal would repeal: (a) the enhanced oil recovery credit for eligible costs attributable to a qualified enhanced oil recovery project; (b) the credit for oil and gas produced from marginal wells; (c) the expensing of intangible drilling costs; (d) the deduction for costs paid or incurred for any qualified tertiary injectant used as part of a tertiary recovery method; (e) the exception to passive loss limitations provided to working interests in oil and natural gas properties; (f) the use of percentage depletion with respect to oil and gas wells; (g) two year amortization of geological and geophysical expenditures by independent producers, instead allowing amortization over the seven-year period used by major integrated oil companies; (h) expensing of exploration and development costs; (i) percentage depletion for hard mineral fossil fuels; (j) capital gains treatment for royalties; (k) the exemption from the corporate income tax for publicly traded partnerships with qualifying income and gains from activities relating to fossil fuels; (l) the

OSTLF excise tax exemption for crude oil derived from bitumen and kerogen-rich rock; and (m) accelerated amortization for air pollution control facilities.

Unless otherwise specified, the proposal provisions would be effective for taxable years beginning after December 31, 2022. In the case of royalties, the proposal provision would be effective for amounts realized after taxable years beginning after December 31, 2022. The repeal of the exemption from the corporate income tax for publicly traded partnerships with qualifying income and gains from activities relating to fossil fuels would be effective for taxable years beginning after December 31, 2027.

MODIFY OIL SPILL LIABILITY TRUST FUND FINANCING AND SUPERFUND EXCISE TAXES

Current Law

An excise tax to finance the Oil Spill Liability Trust Fund (OSLTF) is imposed on: (a) crude oil received at a U.S. refinery; (b) imported petroleum products (including crude oil) entered into the United States for consumption, use, or warehousing; and (c) any domestically produced crude oil that is used (other than on the premises where produced for extracting oil or natural gas) in or exported from the United States if, before such use or exportation, no taxes were imposed on the crude oil. The tax is eight cents per barrel before January 1, 2017, and nine cents per barrel thereafter. Crudes such as those that are produced from bituminous deposits as well as kerogen-rich rock (for example, tar sands) are not treated as crude oil or petroleum products for purposes of the tax. The tax is deposited in the OSLTF to pay costs associated with oil removal and damages resulting from oil spills, as well as to provide annual funding to certain agencies for a wide range of oil pollution prevention and response programs, including research and development. In the case of an oil spill, the OSLTF makes it possible for the Federal government to pay for removal costs up front, and then seek full reimbursement from the responsible parties.

U.S. Code Title 19 (Customs Duties), Section 1313 – Drawbacks and Refunds has been administratively interpreted to allow drawback of the tax when products subject to this tax are exported.

Before January 1, 1996, Superfund excise taxes were imposed on crude oil and imported petroleum products, specific hazardous chemicals, and imported taxable substances. The Infrastructure Investment and Jobs Act reinstates, effective July 1, 2022, the Superfund excise taxes imposed on certain hazardous chemicals and imported taxable substances and increases the tax rates for such chemicals and substances. The revenues from these taxes are dedicated to the Hazardous Substance Superfund Trust Fund. Amounts in the Trust Fund are available for expenditures incurred in connection with releases or threats of releases of hazardous substances into the environment under specified provisions of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (as amended).

Adjusted Baseline

The Build Back Better Act reinstates, effective July 1, 2022, the Superfund excise tax on crude oil and imported petroleum products and increases the tax rate from 9.7 cents per barrel to 16.4 cents per barrel, adjusted annually for inflation. Crudes such as those that are produced from bituminous deposits as well as kerogen-rich rock are not treated as crude oil or petroleum products for purposes of the tax.

Reasons for Change

The magnitude of the Federal response to recent disasters has reinforced the importance of the OSLTF and the need to maintain a sufficient balance in the fund, particularly in order to accommodate spills of national significance. It is appropriate to extend the tax to other sources of

crudes that present environmental risks comparable to those associated with crude oil and petroleum products.

The drawback of the tax is granted when the product is exported even though there is no concomitant reduction in the risk of an oil spill. A prohibition on the drawbacks of the tax will strengthen the finances of the OSLTF and remove an incentive to export crude and like products.

The Superfund excise taxes provide critical financing to remedy damages caused by releases of hazardous substances. As with the OSLTF tax, it is appropriate to extend the Superfund excise tax to other crudes such as those produced from bituminous deposits as well as kerogen-rich rock, as such crudes can also cause environmental contamination.

Proposal

The eligibility of the OSLTF for drawback would be eliminated. In addition, the proposal would extend the Superfund excise tax on crude oil and imported petroleum products to other crudes such as those produced from bituminous deposits as well as kerogen-rich rock.

The proposal would be effective after December 31, 2022.

STRENGTHEN TAXATION OF HIGH-INCOME TAXPAYERS

INCREASE THE TOP MARGINAL INCOME TAX RATE FOR HIGH EARNERS

Current Law

For taxable years beginning after December 31, 2017, and before January 1, 2026, the top marginal tax rate in the tax rate tables is 37 percent. For taxable years beginning after December 31, 2025, the top marginal tax rate for individual income tax is 39.6 percent.

For taxable years beginning after December 31, 2021, and before January 1, 2023, the top marginal tax rate applies to taxable income over \$647,850 for married individuals filing a joint return and surviving spouses, \$539,900 for unmarried individuals (other than surviving spouses) and head of household filers, and \$323,925 for married individuals filing a separate return. The tax bracket thresholds are indexed for inflation.

Reasons for Change

The proposal would raise tax rates for the highest income taxpayers. It would raise revenue while increasing the progressivity of the tax system.

Proposal

The proposal would increase the top marginal tax rate to 39.6 percent. The top marginal 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. After 2023, the thresholds would be indexed for inflation using the C-CPI-U, which is used for all current thresholds in the tax rate tables.

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

REFORM THE TAXATION OF CAPITAL INCOME

Current Law

Most realized long-term capital gains and qualified dividends are taxed at graduated rates based on the taxpayer's taxable income, with 20 percent generally being the highest rate (23.8 percent including the net investment income tax, if applicable based on the taxpayer's modified adjusted gross income). Moreover, capital gains are taxable only upon the sale or other disposition of an appreciated asset. When a donor gives an appreciated asset to a donee during the donor's life, the donee's basis in the asset is the basis of the donor; the basis is "carried over" from the donor to the donee. There is no realization of capital gain by the donor at the time of the gift, and there is no recognition of capital gain by the donee until the donee later disposes of that asset. When an appreciated asset is held by a decedent at death, the basis of the asset for the decedent's heir is adjusted (usually "stepped up") to the fair market value of the asset at the date of the decedent's death. As a result, the appreciation accruing during the decedent's life on assets that are still held by the decedent at death avoids Federal income tax.

Reasons for Change

Preferential tax rates on long-term capital gains and qualified dividends disproportionately benefit high-income taxpayers and provide many high-income taxpayers with a lower tax rate than many low- and middle-income taxpayers. The rate disparity between taxes on capital gains and qualified dividends on the one hand, and taxes on labor income on the other, also encourages economically wasteful efforts to convert labor income into capital income as a tax avoidance strategy.

Under current law, because a person who inherits an appreciated asset receives a basis in that asset equal to the asset's fair market value at the time of the decedent's death, appreciation that had accrued during the decedent's life is never subjected to income tax. In contrast, less-wealthy individuals who must spend down their assets during retirement pay income tax on their realized capital gains. This dynamic increases the inequity of the tax treatment of capital gains. In addition, the preferential treatment for assets held until death produces an incentive for taxpayers to inefficiently lock in portfolios of assets and hold them primarily for the purpose of avoiding capital gains tax on the appreciation, rather than reinvesting the capital in more economically productive investments.

Moreover, the distribution of wealth among Americans has grown increasingly unequal, concentrating economic resources in a steadily shrinking percentage of individuals. Coinciding with this period of growing inequality, the long-term fiscal shortfall of the United States has significantly increased. Reforms to the taxation of capital gains and qualified dividends will reduce economic disparities among Americans and raise needed revenue.

Proposal

Tax capital income for high-income earners at ordinary rates

Long-term capital gains and qualified dividends of taxpayers with taxable income of more than \$1 million would be taxed at ordinary rates, with 37 percent generally being the highest rate (40.8 percent including the net investment income tax).¹¹ The proposal would only apply to the extent that the taxpayer's taxable income exceeds \$1 million (\$500,000 for married filing separately), indexed for inflation after 2023.¹²

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

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

Under the proposal, the donor or deceased owner of an appreciated asset would realize a capital gain at the time of the transfer. The amount of the gain realized would be the excess of the asset's fair market value on the date of the gift or on decedent's date of death over the decedent's basis in that asset. That gain would be taxable income to the decedent on the Federal gift or estate tax return or on a separate capital gains return. The use of capital losses and carry-forwards from transfers at death would be allowed against capital gains and up to \$3,000 of ordinary income on the decedent's final income tax return, and the tax imposed on gains deemed realized at death would be deductible on the estate tax return of the decedent's estate (if any).

Gain on unrealized appreciation also would be recognized by a trust, partnership, or other non-corporate entity that is the owner of property if that property has not been the subject of a recognition event within the prior 90 years. This provision would apply to property not subject to a recognition event since December 31, 1939, so that the first recognition event would be deemed to occur on December 31, 2030.

A transfer would be defined under the gift and estate tax provisions and would be valued at the value used for gift or estate tax purposes. However, for purposes of the imposition of this capital gains tax, the following would apply. First, a transferred partial interest generally would be valued at its proportional share of the fair market value of the entire property, provided that this rule would not apply to an interest in a trade or business to the extent its assets are actively used in the conduct of that trade or business. Second, transfers of property into, and distributions in kind from a trust, other than a grantor trust that is deemed to be wholly owned and revocable by the donor, would be recognition events, as would transfers of property to, and by, a partnership or other non-corporate entity, if the transfers have the effect of a gift to the transferee. The deemed owner of such a revocable grantor trust would recognize gain on the unrealized appreciation in any asset distributed from the trust to any person other than the deemed owner or

¹¹ A separate proposal would first raise the top ordinary rate to 39.6 percent (43.4 percent including the net investment income tax). In addition, the proposal is scored under the assumption of an adjusted baseline which reflects provisions of the Build Back Better Act, as described in the Greenbook preface notes.

¹² For example, a taxpayer with \$1,100,000 in taxable income of which \$200,000 is preferential capital income would have \$100,000 of capital income taxed at the preferential rate and \$100,000 taxed at ordinary rates.

the U.S. spouse of the deemed owner, not including distributions made in discharge of an obligation of the deemed owner. All of the unrealized appreciation on assets of such a revocable grantor trust would be realized at the deemed owner's death or at any other time when the trust becomes irrevocable.

Certain exclusions would apply. Transfers to a U.S. spouse or to charity would carry over the basis of the donor or decedent. Capital gain would not be realized until the surviving spouse disposes of the asset or dies, and appreciated property transferred to charity would be exempt from capital gains tax. The transfer of appreciated assets to a split-interest trust would be subject to this capital gains tax, with an exclusion from that tax allowed for the charity's share of the gain based on the charity's share of the value transferred as determined for gift or estate tax purposes.

The proposal would exclude from recognition any gain on all tangible personal property such as household furnishings and personal effects (excluding collectibles). The \$250,000 per-person exclusion under current law for capital gain on a principal residence would apply to all residences and would be portable to the decedent's surviving spouse, making the exclusion effectively \$500,000 per couple. Finally, the exclusion under current law for capital gain on certain small business stock would also apply.

In addition to the above exclusions, the proposal would allow a \$5 million per-donor exclusion from recognition of other unrealized capital gains on property transferred by gift during life. This exclusion would apply only to unrealized appreciation on gifts to the extent that the donor's cumulative total of lifetime gifts exceeds the basic exclusion amount in effect at the time of the gift. In addition, the proposal would allow any remaining portion of the \$5 million exclusion that has not been used during life as an exclusion from recognition of other unrealized capital gains on property transferred by reason of death. This exclusion would be portable to the decedent's surviving spouse under the same rules that apply to portability for estate and gift tax purposes (resulting in a married couple having an aggregate \$10 million exclusion) and would be indexed for inflation after 2022. 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.

The proposal also includes several deferral elections. Taxpayers could elect not to recognize unrealized appreciation of certain family-owned and -operated businesses until the interest in the business is sold or the business ceases to be family-owned and operated. Furthermore, the proposal would allow a 15-year fixed-rate payment plan for the tax on appreciated assets transferred at death, other than liquid assets such as publicly traded financial assets and other than businesses for which the deferral election is made. The IRS would be authorized to require security at any time when IRS perceives a reasonable need for security to continue this deferral. That security could be provided from any person, and in any form, deemed acceptable by the IRS.

Additionally, the proposal would include other legislative changes designed to facilitate and implement this proposal, including without limitation: the allowance of a deduction for the full cost of appraisals of appreciated assets; the imposition of liens; the waiver of penalty for

underpayment of estimated tax to the extent that underpayment is attributable to unrealized gains at death; the grant of a right of recovery of the tax on unrealized gains; rules to determine who has the right to select the return filed; the achievement of consistency in valuation for transfer and income tax purposes; coordinating changes to reflect that the recipient would have a basis in the property equal to the value on which the capital gains tax is computed; and a broad grant of regulatory authority to provide implementing rules.

To facilitate the transition to taxing gains at gift, death and other events under this proposal, the Secretary and her delegates would be granted authority to issue any regulations or other guidance necessary or appropriate to implement the proposal, including rules and safe harbors for determining the basis of assets in cases where complete records are unavailable, reporting requirements for all transfers of appreciated property including value and basis information, and rules where reporting could be permitted on the decedent's final income tax return instead.

The proposal would be effective for gains on property transferred by gift, and on property owned at death by decedents dying, after December 31, 2022, and on certain property owned by trusts, partnerships, and other non-corporate entities on January 1, 2023.

IMPOSE A MINIMUM INCOME TAX ON THE WEALTHIEST TAXPAYERS

Current Law

Most realized long-term capital gains and qualified dividends are taxed at graduated rates under the individual income tax, with 20 percent generally being the highest rate (23.8 percent including the net investment income tax, if applicable, based on the taxpayer's modified adjusted gross income). Moreover, capital gains are taxable only upon a realization event, such as the sale or other disposition of an appreciated asset. As a result, the Federal income taxation of the appreciation of an asset that accrues during the asset's holding period is deferred. In the case of unrealized appreciation at death, the basis adjustment (usually, a step-up) for a decedent's assets may cause Federal income taxation of that gain to be eliminated entirely.

Reasons for Change

Preferential treatment for unrealized gains disproportionately benefits high-wealth taxpayers and provides many high-wealth taxpayers with a lower effective tax rate than many low- and middle-income taxpayers.

Under current law, the preferential treatment for unrealized gains produces an incentive for taxpayers to inefficiently lock in portfolios of assets and hold them primarily for the purpose of avoiding capital gains tax on the appreciation, rather than reinvesting the capital in more economically productive investments.

Reforms to the taxation of capital gains will reduce economic disparities among Americans and raise needed revenue.

Proposal

The proposal would impose a minimum tax of 20 percent on total income, generally inclusive of unrealized capital gains, for all taxpayers with wealth (that is, the difference obtained by subtracting liabilities from assets) of an amount greater than \$100 million.

Under this proposal, taxpayers could choose to pay the first year of minimum tax liability in nine equal, annual installments. For subsequent years, taxpayers could choose to pay the minimum tax imposed for those years (not including installment payments due in that year) in five equal, annual installments.

A taxpayer's minimum tax liability would equal the minimum tax rate (that is, 20 percent) times the sum of taxable income and unrealized gains (including on ordinary assets) of the taxpayer, less the sum of the taxpayer's unrefunded, uncredited prepayments and regular tax. Payments of the minimum tax would be treated as a prepayment available to be credited against subsequent taxes on realized capital gains to avoid taxing the same amount of gain more than once. The amount of a taxpayer's "uncredited prepayments" would equal the cumulative minimum tax liability assessed (including installment payments not yet due) for prior years, less any amount credited against realized capital gains in prior years.

Uncredited prepayments would be available to be credited against capital gains taxes due upon realization of gains, to the extent that the amount of uncredited prepayments, reduced by the cumulative amount of unpaid installments of the minimum tax (net uncredited prepayments), exceeds 20 percent of unrealized gains. Refunds would be provided to the extent that net uncredited prepayments exceed the long-term capital gains rate (inclusive of applicable surtaxes) times the taxpayer's unrealized gains – such as after unrealized loss or charitable gift. However, refunds would first offset any remaining installment payments of minimum tax before being refundable in cash.

Minimum tax liability would be reduced to the extent that the sum of minimum tax liability and uncredited prepayments exceeds two times the minimum tax rate 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.

For single decedents, net uncredited prepayments in excess of tax liability from gains at death would be refunded to the decedent's estate and would be included in the decedent's gross estate for Federal estate tax purposes. For married decedents, net uncredited prepayments that are unused would be transferred to the spouse or as otherwise provided by the Secretary or her delegates through regulations or other guidance.

Taxpayers with wealth greater than the threshold would be required to report to the IRS on an annual basis, separately by asset class, the total basis and total estimated value (as of December 31 of the taxable year) of their assets in each specified asset class, and the total amount of their liabilities. Tradable assets (for example, publicly traded stock) would be valued using end-of-year market prices. Taxpayers would not have to obtain annual, market valuations of non-tradable assets. Instead, non-tradable assets would be valued using the greater of the original or adjusted cost basis, the last valuation event from investment, borrowing, or financial statements, or other methods approved by the Secretary or her delegates (Secretary). Valuations of non-tradable assets would not be required annually and would instead increase by a conservative floating annual return (the five-year Treasury rate plus two percentage points) in between valuations. The IRS may offer avenues for taxpayers to appeal valuations, such as through appraisal.

This reporting also would be used to determine if the taxpayer is eligible to be treated as "illiquid." Taxpayers would be treated as illiquid if tradeable assets held directly or indirectly by the taxpayer make up less than 20 percent of the taxpayer's wealth. Taxpayers who are treated as illiquid may elect to include only unrealized gain in tradeable assets in the calculation of their minimum tax liability. However, taxpayers making this election would be subject to a deferral charge upon, and to the extent of, the realization of gains on any non-tradeable assets. The deferral charge would not exceed ten percent of unrealized gains.

Estimated tax payments would not be required for minimum tax liability. The minimum tax payment amount would be excluded from the prior year's tax liability for purposes of computing estimated tax required to be paid to avoid the penalty for the underpayment of estimated taxes.

The proposal would provide the Secretary with the authority to prescribe such regulations or other guidance determined to be necessary or appropriate to carry out the purposes of the proposal, including rules to prevent taxpayers from inappropriately converting tradeable assets to non-tradeable assets.

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

SUPPORT FAMILIES AND STUDENTS

MAKE ADOPTION TAX CREDIT REFUNDABLE AND ALLOW CERTAIN GUARDIANSHIP ARRANGEMENTS TO QUALIFY

Current Law

Two tax benefits are provided to taxpayers who adopt children: (a) a nonrefundable 100 percent tax credit for a limited amount of qualified expenses incurred in the adoption of a child; and (b) an exclusion from gross income of a limited amount of qualified adoption expenses paid or reimbursed by an employer under an adoption assistance program. For taxable year 2022 the separate limits on qualified adoption expenses for the credit and the exclusion are \$14,890. Taxpayers may use both adoption tax benefits, but the same expenses cannot be used for both benefits. Taxpayers may claim the credit for domestic and foreign adoptions, although the rules differ.

For domestic adoptions, qualifying expenses paid prior to the year in which the adoption is finalized are allowable as a credit in the year following the year of payment (even if the adoption is never finalized); however, qualifying expenses paid in the year in which the adoption is finalized (or later) are allowable as a credit in the year of payment. For foreign adoptions, the credit may be claimed only in the year the adoption becomes final (or, if later, in the year the qualified expense is paid).

Taxpayers who adopt children with special needs may claim the full \$14,890 credit even if total adoption expenses are less than that amount, although credits in excess of actual expenses may only be claimed for the year the adoption is finalized.

Taxpayers may carry forward unused credit amounts for up to five years.

If modified adjusted gross income (AGI) exceeds \$223,410, both the credit amount and the amount excluded from gross income are reduced pro rata over the next \$40,000 of modified AGI. The maximum credit, the maximum exclusion, and the income at which the phaseout range begins are indexed annually for inflation. The limits for the tax credit and the exclusion are per adoption so that benefits for a given adoption may be claimed over several years.

Reasons for Change

Tax benefits for adoption lower the cost of adoptions. Because adoption credits are currently non-refundable, low- and moderate-income families are unlikely to have sufficient tax liability to benefit from the full amount of the credit to which they are otherwise entitled. This assistance would help low- and moderate-income families afford adoption expenses, potentially making adoption more attainable for these families and ensuring that this credit is available to all taxpayers, regardless of tax liability. Because the adoption process, and therefore the expenses, may extend over several years, it is important that the change to make the adoption credit refundable be made permanent.

There are circumstances where a family might choose to claim legal and financial responsibility for a child via guardianship instead of adoption. Expanding the credit to include families bonded by legal guardianship rather than adoption promotes the goal of creating stability for vulnerable children and provides assistance to the families caring for them.

Proposal

The proposal would make the adoption credit fully refundable. Thus, taxpayers could claim the full amount of any eligible credit in the year that the expense was first eligible regardless of tax liability.

In addition, taxpayers with unused carryforward amounts from eligible expenses from earlier adoptions would be able to claim the full amount of any unused carryforward on their 2023 tax return. However, unused carryforward amounts that expired before 2023 (pursuant to the 5-year limit under current law) would not be eligible to be claimed.

The proposal would also allow families who enter into a guardianship arrangement with a child that meets the requirements below to claim a refundable credit for the expenses related to establishing the guardianship relationship in the year such requirements are satisfied. Unless otherwise specified, eligible expenses and the timing of claims for guardianships would follow existing rules for domestic adoptions.¹³ The extra benefit for special needs adoptions would not be extended to include cases of guardianships.

A guardianship arrangement would be eligible for the credit if four requirements were met: (a) the relationship must be established by court order, (b) the relationship must not be with one's own child or stepchild (as is the case with the adoption credit), (c) the guardian and the child must meet a residency requirement, and (d) the child must be under 18 at the time the relationship was established.

In cases where the child was later adopted by the same individual (or individuals on a joint return), allowable expenses for the adoption credit by this individual (or individuals) would be decreased by the amount already claimed.

The Secretary and her delegates would be granted regulatory authority to develop rules and reporting requirements to ensure that eligibility, relationships, and expenses are well defined and verifiable and to establish cooperation procedures with relevant State and local agencies and courts.

The proposal will be effective for taxable years beginning after December 31, 2022.

¹³ As with adoption, qualified expenses would include court and attorney fees, travel, and other expenses directly related to and for the principal purpose of the establishing guardianship of the child. Taxpayers generally claim a credit for domestic adoption expenses in the taxable year after the expense was paid or incurred, except in the year the adoption is finalized (expenses paid or incurred in the year the adoption is finalized can be claimed as a credit in such year).

PROVIDE INCOME EXCLUSION FOR STUDENT DEBT RELIEF

Current Law

Loan amounts that are forgiven or otherwise discharged are considered gross income to the borrower and subject to individual income tax in the year of discharge. Exceptions are provided in the Internal Revenue Code for some, but not all, education debt. The American Rescue Plan Act of 2021 (ARP) provides an exception to the treatment of discharged loan amounts as gross income for certain qualifying student debt that is discharged after December 31, 2020, and before January 1, 2026.

During the period of the exception, certain forgiven or discharged student loan debt from qualified student loans will be excluded from gross income and thus not subject to taxation. A qualified student loan is a loan that was taken out for the express purpose of funding post-secondary education expenses, subject to specific rules that vary with the characteristics of the originator or insurer of the loan. The tax exclusion is extended to forgiven amounts for both private and public student loans and includes loan amounts borrowed for the education of one's children (that is, Parent PLUS loans).

Reasons for Change

Permanently extending the ARP's tax treatment of discharged student loan debt will encourage lower income borrowers to enroll in income-driven repayment (IDR) plans, remove barriers for colleges and universities seeking to provide relief on debts owed to them by students, and provide relief to borrowers eligible for discharges resulting from legal causes of action. This provision of the ARP conforms the tax treatment of most student loan discharges, including balances under IDR plans, which were taxable in absence of this provision, non-Federal loans (including private education loans), which were taxable in most cases, and the tax treatment of student loans cancelled due to (a) meeting certain work requirements, (b) death or permanent and total disability, or (c) receipt of certain student loan repayment assistance. Conformity eliminates the need for future legislative changes to accommodate specific loan programs that support future policy goals.

Proposal

The proposal would permanently make permanent the ARP exclusion of certain discharged student loan amounts from gross income.

The proposal would be effective on the date of enactment.

MODIFY ESTATE AND GIFT TAXATION

MODIFY INCOME, ESTATE AND GIFT TAX RULES FOR CERTAIN GRANTOR TRUSTS

Current Law

If the grantor who creates a revocable trust, or in certain cases an irrevocable trust, retains certain powers with regard to the trust or its assets (such as the power to control or direct the trust's income or assets), the trust is a grantor trust and the grantor is considered the deemed owner of the trust. The assets of a grantor trust are treated, solely for income tax purposes, as the assets of the deemed owner of the trust, even if the deemed owner is not a beneficiary of the trust. In addition to causing transactions between the grantor trust and its deemed owner to be disregarded for income tax purposes, this feature also generally results in the income tax liability generated by grantor trust assets to be the obligation of the deemed owner, rather than the obligation of the trust or its beneficiaries. No amount paid by the deemed owner of a grantor trust to satisfy this income tax liability is treated as a gift by the deemed owner to the trust or its beneficiaries for Federal gift tax purposes.

Individuals who own assets expected to appreciate in value use two common techniques for reducing estate taxes that exploit the gift and income tax features of grantor trusts to remove value from their gross estates.

The first technique is the funding of a Grantor Retained Annuity Trust (GRAT) with assets that are expected to appreciate in value. A GRAT is an irrevocable grantor trust in which the grantor retains an annuity interest for a term of years that the grantor expects to survive. At the end of that term, the assets then remaining in the trust are transferred to (or held in further trust for) the beneficiaries. At the creation of the GRAT, the gift tax rules determine the value of the grantor's gift of the remainder interest in the GRAT by deducting the then-present value of the grantor's retained annuity interest from the fair market value of the property funding the GRAT. The present value of the grantor's retained annuity interest is the value of the expected payments to the grantor during the GRAT term determined using a discount rate or rate of return based in part on the applicable Federal rate in effect for the month in which the GRAT is funded.

The second technique is the sale of an appreciating asset to a grantor trust by the deemed owner of the trust. Generally, a transaction between a grantor trust and its deemed owner is an event that is disregarded for income tax purposes. Thus, when a taxpayer sells an appreciating asset to a grantor trust of which the taxpayer is the deemed owner for income tax purposes, the taxpayer does not recognize capital gain or loss on the sale and the trust's basis in the asset is the same as the taxpayer's basis before the transaction. In most cases, the taxpayer receives the sales price for the appreciating asset in the form of a note issued by the trust to be paid from the future income or return from the asset sold to the trust.

Reasons for Change

GRATs and grantor trusts allow taxpayers to substantially reduce their combined Federal income, gift, and estate tax obligations through tax planning. A taxpayer can use a GRAT or sell assets to the taxpayer's grantor trust to remove significant value from the taxpayer's gross estate for Federal estate tax purposes without Federal income or gift tax consequences. Reform is necessary to close the relevant loopholes and ensure the effective operation of the Federal income, gift, and estate taxes. To be effective, any change in the law would have to address both techniques; otherwise, taxpayers will simply shift their planning from one technique to the other.

GRATs are also often funded with assets expected to appreciate rapidly in value. To the extent that the value of a GRAT's assets appreciate at a rate that exceeds the relatively low statutory interest rate used to value the grantor's retained annuity interest, that appreciation will have been transferred to the remainder beneficiary or beneficiaries of the GRAT with little or no gift tax. However, if the grantor dies during the GRAT term, almost the entire value of the GRAT assets generally is included in the grantor's gross estate for Federal estate tax purposes. In that event, even though little or no gift tax was incurred, the transfer tax benefits of the GRAT will not have been achieved. To mitigate this risk, the GRAT term is selected to be a number of years that the grantor is expected to survive. To mitigate the tax cost, the GRAT is structured to have a remainder interest with only a very small value. As a result, even if the GRAT is unsuccessful, there has been little to no cost or downside risk for the grantor.

The planning effect of a taxpayer's sale of an appreciating asset to his or her grantor trust is to remove the future appreciation from the taxpayer's gross estate without the payment of gift or estate tax and without the recognition of any capital gain on the sale. In addition, the deemed owner's payment of the income tax on the trust's taxable income and gains each year is considered the owner's payment of his or her own tax liability and therefore not a gift. This allows the property in the trust to grow free of income tax, without any gift tax cost.

Another tax avoidance strategy facilitated by grantor trusts involves a taxpayer who, at some time before the taxpayer's death, repurchases (in another transaction disregarded for income tax purposes) the then-appreciated asset from the grantor trust for the asset's then-fair market value. When the taxpayer dies, the appreciated asset in the grantor's gross estate will have its basis adjusted to its fair market value on the taxpayer's date of death, so any unrealized appreciation is not subjected to capital gains tax. The trust then will have the same value as before the repurchase but without the future capital gains tax liability for the unrealized gain on that asset.

Proposal

The proposal would require that the remainder interest in a GRAT at the time the interest is created have a minimum value for gift tax purposes equal to the greater of 25 percent of the value of the assets transferred to the GRAT or \$500,000 (but not more than the value of the assets transferred). In addition, the proposal would prohibit any decrease in the annuity during the GRAT term and would prohibit the grantor from acquiring in an exchange an asset held in the trust without recognizing gain or loss for income tax purposes. Finally, the proposal would require that a GRAT have a minimum term of ten years and a maximum term of the life

expectancy of the annuitant plus ten years. These provisions would impose some downside risk on the use of GRATs so they are less likely to be used purely for tax avoidance purposes.

For trusts that are not fully revocable by the deemed owner, the proposal would treat the transfer of an asset for consideration between a grantor trust and its deemed owner or any other person 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 basis of the transferred asset in the hands of the buyer being 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. However, securitization transactions would not be subject to this new provision.

The proposal also would provide that the payment of the income tax on the income of a grantor trust is a gift. That gift occurs on December 31 of the year in which the income tax is paid (or, if earlier, immediately before the owner's death, or on the owner's renunciation of any reimbursement right for that year) unless the deemed owner is reimbursed by the trust during that same year. The amount of the gift is the unreimbursed amount of the income tax paid.

The GRAT portion of the proposal would apply to all trusts created on or after the date of enactment. The portion of the proposal characterizing the grantor's payment of income taxes as a gift also would apply to all trusts created on or after the date of enactment. The gain recognition portion of the proposal would apply to all transactions between a grantor trust and its deemed owner occurring on or after the date of enactment. It is expected that the legislative language providing for such an immediate effective date would appropriately detail the particular types of transactions to which the new rule does not apply.

REQUIRE CONSISTENT VALUATION OF PROMISSORY NOTES

Current Law

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 income tax purposes. The Internal Revenue Code requires minimum rates of interest based on the duration of a note or other loan (its term); the IRS issues monthly rates for each term. These rates effectively create a safe harbor: if the interest rate on a loan is at least equal to the minimum rate of interest specified by the IRS for a loan of the same term, the loan avoids being a “below-market loan” (the forgone interest on which is subject to income tax) and the loan is not treated as a gift for gift tax purposes.

Reasons for Change

The rules for below-market loans allow a taxpayer to take inconsistent positions regarding the valuation of a loan and thereby achieve a tax savings. Typically, a taxpayer sells a valuable asset intra-family for a promissory note carrying the minimum interest rate required to ensure that the loan is not taxed as a “below-market loan” for income tax purposes. The taxpayer claims that the minimum interest rate is sufficient to avoid both the treatment of any foregone interest on the loan as imputed income to the lender and the treatment of any part of the transaction as a gift. However, in subsequently valuing that unpaid note for Federal estate tax purposes after the death of the taxpayer, the estate takes the position that the fair market value of the note should be discounted because the interest rate is well below the market rate at the time of the taxpayer’s death. In other words, the taxpayer relies on the statutory rules to assert that the loan is not below market for gift tax purposes at the time of the transaction and relies on the underlying economic characteristics to assert the loan is below market for estate tax purposes later. Because the prescribed minimum interest rates for promissory notes have been so low for at least the past decade, the use of these notes has become a popular tax planning technique to reduce gift and estate taxes.

Alternatively, the term of a promissory note may be very lengthy, and at death, the holder’s estate may claim a significant discount on the value of the unpaid note based on the amount of time before the note will be paid in full.

Proposal

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 and her delegates (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 actual interest rate of the note. In addition, the term of the note would be treated as being short term regardless of the due date, or

term loans would be valued as demand loans in which the lender can require immediate payment in full, if there is a reasonable likelihood that the note will be satisfied sooner than the specified payment date and in other situations as determined by the Secretary.

The proposal would apply to valuations as of a valuation date on or after the date of introduction.

IMPROVE TAX ADMINISTRATION FOR TRUSTS AND DECEDENTS' ESTATES

Current Law

Definition of executor

Section 2203 of the Internal Revenue Code (Code) defines “executor” for purposes of the estate tax to be the person who is appointed, qualified, and acting within the United States as executor or administrator of the decedent’s estate or, if none, then “any person in actual or constructive possession of any property of the decedent” who is considered a “statutory” executor. A “statutory” executor is a person who is not appointed by a court but has an obligation to file an estate tax return because they possess assets of the decedent. A statutory executor could include, for example, the trustee of the decedent’s revocable trust, a beneficiary of an Individual Retirement Account (IRA) or life insurance policy, or a surviving joint tenant of jointly owned property.

Limit on the reduction in value of special use property

Generally, the fair market value of real property for estate tax purposes is based on the property’s value at its “highest and best use.” For example, an undeveloped parcel of land might be valued as property that could be developed for residential or commercial purposes. However, the estates of owners of certain real property used in a family-owned trade or business may reduce the value of that property for Federal estate tax purposes below its value at its highest and best use to help preserve its current use. The maximum reduction in value is limited to \$750,000, as adjusted for inflation since 1997; in 2022, the reduction in value is capped at \$1.23 million.

Ten-year period for certain estate and gift tax liens

Current law provides an automatic 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. The lien remains in effect for 10 years from the date of the gift for gift tax, or the date of the decedent’s death for estate tax, unless the tax is sooner paid in full.

Reporting of estimated total value of trust assets

Although most domestic trusts are required to file an annual income tax return, there is no requirement to report the nature or value of assets held by a domestic trust. As a result, the IRS has no statistical data on the magnitude of wealth held in domestic trusts. Other agencies collect data on the amount of wealth held in some, but not other, types of domestic trusts. In contrast, private foundations are required to report both the basis and fair market value of their assets on their annual tax return. While some of that asset information is required to compute the foundation’s excise tax liability and distribution requirements, that information also provides statistical data to the IRS that can be used for various tax administration purposes and in developing tax policies.

Reasons for Change

Expand definition of executor

Because the statutory definition of executor currently applies only for estate tax purposes, a statutory executor (including a surviving spouse who filed a joint income tax return) has no authority to represent the decedent or the estate with regard to the decedent's final income tax liabilities, failures to report foreign assets, or other tax liabilities and obligations that arose prior to the decedent's death. Similarly, no one has the authority to extend a limitations statute, claim a refund, agree to a compromise or assessment, or pursue judicial relief with regard to a tax liability of the decedent. Problems associated with this absence of any representative authority have started to arise more frequently, as reporting obligations (particularly regarding an interest in a foreign asset or account) have increased.

Additionally, in the absence of an appointed executor, multiple different persons may meet the definition of executor and, on occasion, more than one of them has each filed a separate estate tax return for the decedent's estate or they have made conflicting tax elections.

Increase the limit on the reduction in value of special use property

The inflation adjustments since 1997 have not kept up with the increases in the value of real property over that same time period, causing this special use valuation provision to be of diminishing benefit to decedents' estates.

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

Under current law, this 10-year lien cannot be extended, including in cases where the taxpayer enters into an agreement with the IRS to defer tax payments or to pay taxes in installments that extend beyond 10 years. Thus, for unpaid amounts due to be paid after the 10-year period, this special lien has no effect.

Require reporting of estimated total value of trust assets

Because of the lack of statistical data on the nature and value of assets held in trusts in the United States, it is difficult to develop the administrative and legal structures capable of effectively implementing appropriate tax policies and evaluating compliance with applicable statutes and regulations. Because so much wealth currently is held in domestic trusts, the lack of this data hampers efforts to design tax policies intended to increase the equity and progressivity of the tax system.

Proposal

Expand definition of executor

To empower an authorized party to act on behalf of the decedent in such matters, the proposal would move the existing definition of executor from section 2203 to section 7701 of the Code,

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. Because this definition frequently results in multiple parties being an executor, the proposal also would grant regulatory authority to the Secretary and her delegate (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.

Increase the limit on the reduction in value of special use property

The proposal would increase the cap on the maximum valuation decrease for "qualified real property" elected to be treated as special use property to \$11.7 million. Such property generally would include the real estate used in family farms, ranches, timberland, and similar enterprises.

The proposal would apply to the estates of decedents dying on or after the date of enactment.

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

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.

Require reporting of estimated total value of trust assets

The proposal would require certain trusts administered in the United States, whether domestic or foreign (other than a trust subject to the reporting requirements of section 6048(b) of the Code), to report certain information to the IRS on an annual basis to facilitate the appropriate analysis of tax data, the development of appropriate tax policies, and the administration of the tax system. That reporting could be done on the annual income tax return or otherwise, as determined by the Secretary, and would include the name, address, and TIN of each trustee and grantor of the trust, and general information with regard to the nature and estimated total value of the trust's assets as the Secretary may prescribe. Such reporting on asset information might be satisfied by identifying an applicable range of estimated total value on the trust's income tax return. This reporting requirement for a taxable year would apply to each trust whose estimated total value on the last day of the taxable year exceeds \$300,000 or whose gross income for the taxable year exceeds \$10,000.

The proposal would apply for taxable years ending after the date of enactment.

LIMIT DURATION OF GENERATION-SKIPPING TRANSFER TAX EXEMPTION

Current Law

The generation-skipping transfer (GST) tax is imposed on gifts and bequests by an individual transferor to transferees who are two or more generations younger than the transferor. Each individual has a lifetime GST tax exemption (\$12.06 million in 2022) that can be allocated to transfers made, whether directly or in trust, by that individual to a grandchild or other “skip person.” The allocation of GST exemption to a transfer or to a trust excludes from the GST tax not only the amount of assets to which GST exemption is allocated, but also all subsequent appreciation and income on that amount during the existence of the trust.

The portion of the transferred property or of a trust not shielded from tax by the allocated GST exemption, and thus the portion of the property to which GST tax will apply, is determined by multiplying the value of the property or trust by a factor referred to as the inclusion ratio. The allocation of GST exemption changes the inclusion ratio (which can range from one to zero) applicable to the transferred property or trust.

Reasons for Change

While property remains in a trust, no estate tax is imposed at the death of any trust beneficiary because the beneficiary typically has no rights to the trust property that would cause the property to be includable in the deceased beneficiary’s gross estate for Federal estate tax purposes. At the termination of the trust, however, the trust assets are required to vest in one or more persons, thus becoming the property of those persons and reentering the gift and estate tax base.

At the time of the enactment of the GST provisions, the law of most States included the common law Rule Against Perpetuities (RAP) or some statutory version of it requiring that every trust terminate no later than 21 years after the death of a person who was alive at the time the trust was created. Today, many States either have limited the application of their RAP statutes (permitting trusts to continue for several hundred or up to 1,000 years), or entirely repealed their RAP statute. In those States, as a practical matter, trusts are permitted to continue in perpetuity, so the property in those trusts have been permanently removed from the estate and gift tax base.

Proposal

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.¹⁴ However,

¹⁴ The three types of GST transfers are direct skips, taxable distributions, and taxable terminations. Section 2612 of the Internal Revenue Code defines a direct skip as a transfer to a skip person that is subject to Federal estate or gift tax; a skip person generally is one assigned to a generation more than one generation below that of the transferor. See section 2612 for definitions of a taxable distribution and taxable termination.

section 2653 of the Internal Revenue Code (Code) would not apply for these purposes.¹⁵ In addition, 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. The result of these proposals is that the benefit of the GST exemption that shields property from the GST tax would not last as long as the trust. Instead, it would shield the trust assets from GST tax only as long as the life of any trust beneficiary who either is no younger than the transferor's grandchild or is a member of a younger generation but who was alive at the creation of the trust.

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. Because contributions to a trust from different grantors are deemed to be held in separate trusts under section 2654(b) of the Code, each such separate trust would be subject to the same rule for the duration of the exemption, measured from the date of the first contribution by the grantor of that separate trust. The special rule for pour-over trusts under section 2653(b)(2) would continue to apply to pour-over trusts and to trusts created under a decanting authority, and for purposes of this rule, such trusts would be deemed to have the same date of creation as the initial trust.¹⁶ The other rules of section 2653 would continue to apply and would be relevant in determining when a taxable distribution or taxable termination occurs. An express grant of regulatory authority to the Secretary and her delegates would be included to facilitate the implementation and administration of this provision.

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.

¹⁵ Section 2653 "resets" the generation assignment of trust beneficiaries once GST tax has been imposed, treating younger generations of skip persons as being in the first generation below that of the transferor (and thus as non-skip persons).

¹⁶ A pour-over trust is a trust created alongside a pour-over will, which is a will that directs any remaining assets to the trust upon death. In general, decanting involves distributing assets from one trust to another trust, in order to change the terms of the trust.

CLOSE LOOPHOLES

TAX CARRIED (PROFITS) INTERESTS AS ORDINARY INCOME

Current Law

A partnership is not subject to Federal income tax. Instead, an item of income or loss of the partnership retains its character and flows through to the partners who must include such item on their tax returns. Generally, certain partners receive partnership interests in exchange for contributions of cash and/or property, while certain partners (not necessarily other partners) receive partnership interests, typically interests in future partnership profits referred to as “profits interests” or “carried interests,” in exchange for services. Accordingly, if and to the extent a partnership recognizes long-term capital gain, the partners, including partners who provide services, will reflect their shares of such gain on their tax returns as long-term capital gain. If the partner is an individual, such gain would be taxed at the reduced rates for long-term capital gains. Gain recognized on the sale of a partnership interest, whether it was received in exchange for property, cash, or services, is generally capital gain. Section 1061 of the Internal Revenue Code (Code) generally extends the long-term holding period requirement for certain capital gains resulting from partnership property dispositions and from partnership interest sales, from one year to three years.

Under current law, income attributable to a profits interest is generally subject to self-employment tax, except to the extent the partnership generates types of income that are excluded from self-employment taxes, including capital gains, certain interest, and dividends. A limited partner’s distributive share is generally excluded from self-employment under section 1402(a)(13) of the Code.

Reasons for Change

Although profits interests are structured as partnership interests, the income allocable to such interests is received in connection with the performance of services. A service provider’s share of the income of a partnership attributable to a carried interest should be taxed as ordinary income and subject to self-employment tax because such income is derived from the performance of services. By allowing service partners to receive capital gains treatment on labor income without limit, even with the holding period extension provided by section 1061, the current system creates an unfair and inefficient tax preference. Activity among large private equity firms and hedge funds has increased the breadth and cost of this tax preference, with some of the highest-income Americans benefiting from this preferential treatment.

Proposal

The proposal would generally tax as ordinary income a partner’s share of income on an “investment services partnership interest” (ISPI) in an investment partnership, regardless of the character of the income at the partnership level, if the partner’s taxable income (from all sources) exceeds \$400,000. Accordingly, such income would not be eligible for the reduced rates that

apply to long-term capital gains. In addition, the proposal would require partners in such investment partnerships to pay self-employment taxes on ISPI income if the partner's taxable income (from all sources) exceeds \$400,000. In order to prevent income derived from labor services from avoiding taxation at ordinary income rates, this proposal assumes that the gain recognized on the sale of an ISPI would generally be taxed as ordinary income, not as capital gain, if the partner is above the income threshold. To ensure more consistent treatment with the sales of other types of businesses, the Administration remains committed to working with Congress to develop mechanisms to assure the proper amount of income recharacterization where the business has goodwill or other assets unrelated to the services of the ISPI holder.

An ISPI is a profits interest in an investment partnership that is held by a person who provides services to the partnership. A partnership is an investment partnership if substantially all of its assets are investment-type assets (certain securities, real estate, interests in partnerships, commodities, cash or cash equivalents, or derivative contracts with respect to those assets), but only if over half of the partnership's contributed capital is from partners in whose hands the interests constitute property not held in connection with a trade or business. To the extent (a) the partner who holds an ISPI contributes "invested capital" (which is generally money or other property) to the partnership, and (b) such partner's invested capital is a qualified capital interest, income attributable to the invested capital would not be recharacterized and would continue to be eligible for capital gain treatment. A qualified capital interest is generally one where (a) the partnership allocations to the invested capital are made in the same manner as allocations to other capital interests held by partners who do not hold an ISPI and (b) the allocations to these non-ISPI holders are significant. Similarly, the portion of any gain recognized on the sale of an ISPI that is attributable a qualified capital interest would be treated as capital gain. However, "invested capital" would not include contributed capital that is attributable to the proceeds of any loan or advance made or guaranteed by any partner or the partnership (or any person related to such persons) to a person who holds an ISPI.

Also, any person who performs services for any entity and holds a "disqualified interest" in the entity would be subject to tax at rates applicable to ordinary income on any income or gain received with respect to the interest, if the person's taxable income (from all sources) exceeds \$400,000. A "disqualified interest" is defined as convertible or contingent debt, an option, or any derivative instrument with respect to the entity (but does not include a partnership interest, stock in certain taxable corporations, or stock in an S corporation). This would act as an anti-abuse rule and prevent avoidance of the proposal's application through the use of compensatory arrangements other than partnership interests. Additional anti-abuse rules could be necessary.

The proposal is not intended to adversely affect qualification of a real estate investment trust owning a profits interest in a real estate partnership.

The proposal would repeal section 1061 for taxpayers with taxable income (from all sources) in excess of \$400,000.

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

REPEAL DEFERRAL OF GAIN FROM LIKE-KIND EXCHANGES

Current Law

Currently, owners of appreciated real property used in a trade or business or held for investment can defer gain on the exchange of the property for real property of a “like-kind.” As a result, the tax on the gain is deferred until a later recognition event, provided that certain requirements are met.

Reasons for Change

The proposal would treat the exchanges of real property used in a trade or business (or held for investment) similarly to sales of real property, resulting in fewer distortions.

The change would raise revenue while increasing the progressivity of the tax system. It would also align the treatment of real property with other types of property.

Proposal

The proposal would allow the deferral of gain up to an aggregate amount of \$500,000 for each taxpayer (\$1 million in the case of married individuals filing a joint return) each year for real property exchanges that are like-kind. Any gains from like-kind exchanges in excess of \$500,000 (or \$1 million in the case of married individuals filing a joint return) a year would be recognized by the taxpayer in the year the taxpayer transfers the real property subject to the exchange.

The proposal would be effective for exchanges completed in taxable years beginning after December 31, 2022.

REQUIRE 100 PERCENT RECAPTURE OF DEPRECIATION DEDUCTIONS AS ORDINARY INCOME FOR CERTAIN DEPRECIABLE REAL PROPERTY

Current Law

In general, a taxpayer recognizes gain or loss upon the disposition of an asset used in a trade or business. Such gain or loss can have the character of a capital gain or loss or an ordinary gain or loss according to various provisions of the Internal Revenue Code (Code). Generally, ordinary losses are deductible against a taxpayer's gross income, but capital losses may only offset capital gains.¹⁷ Gains and losses from the sale or exchange of capital assets that have been held for more than one year generally are long-term capital gains and losses. A net capital gain (the excess of a net long-term capital gain over a net short-term capital loss) recognized by a noncorporate taxpayer is generally taxed at lower tax rates than those imposed on ordinary income. Corporations are taxed at the same rate for net capital gains and ordinary income.

A portion of all of the gain recognized upon the disposition of property used in a trade or business or held for investment may be treated as ordinary income to the extent such gain reflects some or all of the depreciation allowances previously deducted against the taxpayer's gross ordinary income (depreciation recapture). In general, any recognized gain on "section 1245 property" is recaptured as ordinary income up to 100 percent of the cumulative depreciation deductions taken with respect to the property. Section 1245 property primarily consists of intangible depreciable property, personal tangible depreciable property, any real property that is subject to special expensing or amortization rules (such as under section 179 of the Code), and certain real depreciable property (other than buildings and structural components) used as an integral part of manufacturing, production, or extraction, or of furnishing transportation, communications, and utility services. Buildings and certain other real property are section 1250 property. For section 1250 property, the amount of recognized gain subject to depreciation recapture equals the amount by which cumulative depreciation deductions exceed the sum of depreciation allowances determined by using the straight-line depreciation method and the property's applicable depreciation cost recovery period.

The section 1250 property depreciation recapture rules generally have little or no effect on recharacterizing gain as ordinary income upon the disposition of section 1250 property, because most section 1250 property is ineligible for the additional first-year bonus depreciation allowance and already uses the straight-line depreciation method and applicable recovery period.¹⁸

Property used in a trade or business is not a capital asset, and gains and losses recognized from the sale, exchange, or involuntary conversion of such property are generally treated as ordinary income and ordinary loss. However, when held for more than a year, most depreciable property and other real property (for example, land) used in a trade or business are defined as "section

¹⁷ Noncorporate taxpayers can deduct up to \$3,000 of the excess capital losses over capital gains.

¹⁸ Section 1250 property that is "qualified improvement property" is eligible for the additional first year bonus depreciation allowance only if the property is placed in service after December 31, 2017. Qualified improvement property is an improvement made to the interior portion of a non-residential building that is placed in service after the building is first placed in service.

1231 property” and subjected to additional rules that determine whether gain or loss from a sale, exchange, or disposition of such property is classified as capital or ordinary.¹⁹ The sum of the gains on section 1231 property (other than gains treated as ordinary income under the depreciation recapture rules) is compared to the sum of the losses on section 1231 property. If the taxpayer’s section 1231 losses exceed its section 1231 gains for a taxable year, then such section 1231 losses and section 1231 gains are treated as ordinary losses and ordinary income, respectively. However, if the section 1231 gains exceed the section 1231 losses for a taxable year, then such gains and losses are generally treated as capital gains and capital losses, respectively. A taxpayer’s aggregate net section 1231 gain for any taxable year is nevertheless treated as ordinary income to the extent it does not exceed the amount of net section 1231 losses incurred in the five preceding taxable years (to the extent such losses have not already been “recaptured” in this manner).

For noncorporate taxpayers, any gain on section 1250 property that represents unrecaptured depreciation (and is treated as capital gain after application of the above rules) is taxed using a maximum tax rate of 25 percent.

Reasons for Change

For noncorporate taxpayers, most gains on buildings or other real property used in the taxpayer’s trade or business are taxed at reduced rates because of the rules of sections 1250 and 1231 of the Code. When taxpayers are able to claim depreciation deductions against ordinary income in excess of the actual decline in value of real property while paying tax on any gains at reduced rates, they are able to convert ordinary income into preferentially taxed capital income. This provides a tax subsidy for noncorporate real estate businesses.²⁰ Applying 100 percent depreciation recapture to the cumulative depreciation deductions on section 1250 property would eliminate this tax subsidy and opportunity for conversion of income. It would raise revenue while increasing the progressivity of the tax system.

The 100 percent recapture of the cumulative depreciation deductions on section 1250 property would promote efficiency and simplification as it would gradually remove the existing disparate tax treatment of section 1250 and section 1245 properties. However, sales of real estate would continue to require an allocation of sales price between land (non-depreciable property) and depreciable property and separate calculations of gain.

While the 100 percent section 1250 depreciation recapture would also apply to C corporations, it would have minimal impact on them because there is no tax rate differential between ordinary net gains and capital net gains of such taxpayers. However, a reduction in capital gains from dispositions of depreciable real estate would result in lower net section 1231 capital gains, and this could lead to higher overall net capital losses for certain corporations. Such net capital losses would not be deductible in the current taxable year and would have to be carried forward to future taxable years.

¹⁹ Inventory, certain intangibles, and assets held for investment purposes are not considered property used in a trade or business and are not section 1231 property.

²⁰ Approximately 75 percent of section 1231 gains distributed to individual partners or shareholders by passthrough businesses are in the real estate sector.

Proposal

Upon disposition, any measured gain on an item of section 1250 property held for more than one year would be treated as ordinary income to the extent of the cumulative depreciation deductions taken after the effective date of the provision. Depreciation deductions taken on section 1250 property prior to the effective date would continue to be subject to current rules and recaptured as ordinary income only to the extent such depreciation exceeds the cumulative allowances determined under the straight-line method. Any gain recognized on the disposition of section 1250 property in excess of recaptured depreciation would be treated as section 1231 gain. Any unrecaptured gain on section 1250 property would continue to be taxed to noncorporate taxpayers at a maximum 25 percent rate.

The proposal would not apply to noncorporate taxpayers with adjusted taxable income (AGI) below \$400,000 (\$200,000 for married individuals filing separate returns).²¹ Partnerships and S corporations would be required to compute the character of gains and losses on business-use property (including section 1250 property, section 1245 property, and land) at the entity level and to report to entity owners the relevant amounts for ordinary income (loss), capital gain (loss), and unrecaptured section 1250 gain under both “new law” and “old law”. Those taxpayers with income of at least the threshold amount would use the “new law” amounts in completing their tax returns.

The proposal would be effective for depreciation deductions taken on section 1250 property in taxable years beginning after December 31, 2022, and sales, exchanges, involuntary conversions, or other dispositions of section 1250 property completed in taxable years beginning after December 31, 2022.

²¹ The taxpayer’s AGI is determined before applying the proposed change to 100-percent depreciation recapture of section 1250 property for purposes of calculating the \$400,000 (\$200,000 for married filing separate returns) threshold.

LIMIT A PARTNER’S DEDUCTION IN CERTAIN SYNDICATED CONSERVATION EASEMENT TRANSACTIONS

Current Law

A charitable contribution deduction is generally allowable for contributions of cash and other property to tax-exempt charitable organizations and to governmental entities. A deduction is generally not allowable for contributions of a partial interest (that is, contributions of less than the taxpayer’s entire interest in property). There is an exception to the partial interest rule, however, for “qualified conservation contributions.” A qualified conservation contribution is the contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes.

Conservation easements are a common type of qualified conservation contribution. Essentially, a conservation easement is a legal agreement placing a restriction (granted in perpetuity) on the use that may be made of the real property. Conservation purposes for such easements include, among other things, the protection of a relatively natural habitat of fish, wildlife, or plants and the preservation of a certified historic structure.

If the easement property is long-term capital gain property (generally, a capital asset that has been held for more than one year), the taxpayer may deduct the fair market value of the donated easement, determined as of the time of the contribution.²² In determining the period for which the taxpayer has held property, if the taxpayer contributes the property to a partnership, current law adds to the partnership’s holding period the period for which such property was held by the donor. Thus, if a landowner who owned land for more than one year contributes the land to a partnership in exchange for a partnership interest, the partnership is treated as if it held the land for more than one year. The partnership could then donate an easement on the property to a qualified organization, generating a charitable contribution deduction for the fair market value of the donated easement that could pass through to the partners in the partnership.

Reasons for Change

Deductions for contributions of conservation easements are a means of encouraging landowners to restrict development of their ecologically valuable land and historic buildings. Where conservation easements significantly reduce the value of the underlying interests, economic incentives are needed to encourage landowners to voluntarily restrict development.

However, in some abusive cases, tax-shelter promoters are syndicating conservation easement transactions that purport to give investors the opportunity to claim charitable contribution deductions in amounts that significantly exceed the amount invested.

Typically, promoters of these schemes identify a pass-through entity that owns real property or form a pass-through entity to acquire real property. The promoters syndicate ownership interests

²² Otherwise, the value of the contribution must be reduced by the amount of gain that would not have been long-term capital gain if the property contributed had been sold at its fair market value, generally resulting in a reduction to the taxpayer’s basis in the property contributed.

in the pass-through entity or tiered entities that own the real property, suggesting to prospective investors that they may be entitled to a share of a charitable contribution deduction that greatly exceeds the amount of an investor's investment. Because of the way that the current holding period rules work, nearly all syndicated conservation easement transactions involve contributions that are treated as contributions of long-term capital gain property. In addition, current law does not tie the amount of a partner's syndicated conservation contribution deduction to the partner's investment in the transaction. The promoters obtain an inflated appraisal of the conservation easement based on unreasonable factual assumptions and conclusions about the development potential of the real property, creating an inflated charitable deduction for the partners.

In Notice 2017-10, the IRS advises that certain of these transactions are tax avoidance transactions and, effective December 23, 2016, identifies them and similar transactions as listed transactions.²³ The notice applies to transactions in which the promotional materials suggest to prospective investors that they may be entitled to a share of a charitable contribution deduction that equals or exceeds two and a half times the amount invested. However, since the Notice was published, the number of individual participants in these transactions has increased.

Proposal

The proposal would provide that a contribution by a partnership (whether directly or as a distributive share of a contribution of another partnership) is not treated as a qualified conservation contribution (and thus, the deduction for the contribution is disallowed) if the amount of such contribution exceeds two and a half times the sum of each partner's relevant basis in such partnership. However, the disallowance would not apply if a three-year holding period requirement is satisfied.

The disallowance would also not apply to certain partnerships and other pass-through entities substantially all of the interests in which are held, directly or indirectly, by an individual and members of the family of such individual.

The proposal would be effective for contributions made in taxable years ending after December 23, 2016, or, in the case of contributions to preserve a certified historic structure, for contributions made in taxable years beginning after December 31, 2018.

²³ A listed transaction is a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary or her delegates as a tax avoidance transaction.

LIMIT USE OF DONOR ADVISED FUNDS TO AVOID PRIVATE FOUNDATION PAYOUT REQUIREMENT

Current Law

Private nonoperating foundations are generally required to annually distribute at least 5 percent of the total fair market value of their non-charitable use assets from the preceding taxable year. A foundation that fails to meet this minimum distribution requirement is subject to a 30 percent excise tax on the undistributed amount.

Qualifying distributions (those that satisfy the distribution requirement) include amounts paid to accomplish religious, charitable, scientific, or educational purposes, as well as reasonable and necessary administrative expenses paid by the foundation to further its charitable purposes.

Qualifying distributions do not include the private foundation's contributions to either an organization controlled directly or indirectly by the private foundation's disqualified person(s),²⁴ or to another private nonoperating foundation, unless (a) not later than one year after the end of the taxable year in which the donee organization received the contribution, the receiving organization makes a distribution equal to the full amount of the contribution and the distribution is a qualifying distribution that is treated as being made out of corpus (or would be so treated if the donee organization were a private nonoperating foundation) and (b) the foundation making the contribution obtains adequate records or enough other evidence from the donee showing that the donee has made a qualifying distribution.

Qualifying distributions also do not include the private foundation's contributions to a Type I, Type II, or functionally integrated Type III supporting organization²⁵ if any of the private foundation's disqualified persons directly or indirectly control the organization or a supported organization of such organization.

Finally, qualifying distributions do not include the private foundation's contributions to non-functionally integrated Type III supporting organizations, even though those organizations are subject to an annual 3.5 percent payout requirement.

Private foundations can set up donor advised funds (DAFs). A DAF is defined as a fund or account which is (a) separately identified by reference to contributions of a donor or donors, (b) owned and controlled by a sponsoring organization, and (c) with respect to which a donor (or any person appointed or designated by such donor) has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in such fund by reason of the donor's status as a donor. There is currently no requirement that amounts held in a DAF be

²⁴ Disqualified persons are defined generally as substantial contributors to the foundation, foundation managers, owners of more than 20 percent of certain entities that are substantial contributors to the foundation, family members of the foregoing, and certain entities in which the foregoing, alone or together, own more than 35 percent.

²⁵ A supporting organization is classified as a Type I, Type II or Type III supporting organization based on the type of relationship it has with its supported organization(s). Type III supporting organizations are further classified as functionally integrated and non-functionally integrated. For more information, see section 509(a)(3) of the Internal Revenue Code and the regulations thereunder.

distributed within any set period of time. Under current law, a distribution by a private foundation to a DAF is generally considered a qualifying distribution.

Reasons for Change

Because a private foundation has advisory privileges with respect to a DAF to which it contributes, and because there is no requirement for a DAF to make a further distribution of funds for a charitable purpose within any set period of time, it is not appropriate for a private foundation to satisfy its distribution requirement by making a distribution to a DAF. This use of DAFs can subvert the goal behind requiring minimum distributions, by reducing the current charitable use of the associated funds.

Proposal

The proposal would clarify that a distribution by a private foundation to a DAF is not a qualifying distribution unless (a) the DAF funds are expended as a qualifying distribution by the end of the following taxable year and (b) the private foundation maintains adequate records or other evidence showing that the DAF has made a qualifying distribution within the required time frame.

The proposal would be effective after the date of enactment.

EXTEND THE PERIOD FOR ASSESSMENT OF TAX FOR CERTAIN QUALIFIED OPPORTUNITY FUND INVESTORS

Current Law

Section 6501 of the Internal Revenue Code (Code) generally requires the IRS to assess a tax within three years after the filing of a tax return, subject to several exceptions.

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. Pursuant to statute, recognition of that gain is deferred until December 31, 2026, or an earlier date on which there occurs any of various inclusion events.²⁶

Reasons for Change

Although deferral for all taxpayers must end not later than December 31, 2026, inclusion events may require some taxpayers to recognize the deferred gain before that date. In many cases, the only manifestation of the inclusion event on the taxpayer's return is the inclusion of the deferred gain in gross income. Thus, inclusion events that occur prior to December 31, 2026, may not be readily identifiable on the taxpayer's return and there is an increased risk that the IRS may be barred from assessing a deficiency arising from the inclusion event by the expiration of the typical three-year statute of limitations.

Proposal

The proposal would provide that if an inclusion event requires deferred gain to be included in gross income, but if a taxpayer fails properly to include it or if the taxpayer in any other way fails to properly reflect on one or more tax returns this required inclusion, then there would be an extension of the time during which the IRS may assess any deficiency in any tax where the deficiency results directly or indirectly from these failures. The time during which these deficiencies may be assessed would not expire before the date that is three years after the date on which the IRS is furnished with all of the information that it needs to assess these deficiencies.

The proposal generally would be effective for inclusions of deferred gains with respect to which deferral elections had been based on investments in QOFs that are made after December 22, 2017 (the date of enactment of the Tax Cuts and Jobs Act of 2017). The proposal, however, would not apply in situations where the statute of limitations for assessment has expired before the date of enactment.

²⁶ Examples of inclusion events include certain events (a) that reduce a taxpayer's direct equity interest in a QOF, (b) in which a taxpayer receives property with respect to its interest in a QOF and the event is treated as a distribution for Federal income tax purposes, (c) in which a taxpayer claims a loss for worthless stock or otherwise claims a worthlessness deduction with respect to its interest in a QOF, and (d) in which a QOF loses its status as a QOF.

ESTABLISH AN UNTAXED INCOME ACCOUNT REGIME FOR CERTAIN SMALL INSURANCE COMPANIES

Current Law

The taxable income of a non-life insurance company is generally the sum of the company's underwriting income (consisting of earned premiums, less incurred insurance losses and expenses), investment income, gains on the disposition of property, and other income items, reduced by allowable deductions. However, certain small non-life insurance companies may elect to be taxed under an alternative tax regime. Under this alternative regime, electing companies are taxed only on their taxable investment income, which consists of interest, dividends, rents, royalties, capital gains, certain non-insurance trade or business income, and similar items, less deductions related to such income, including deductions for tax-exempt interest, capital losses, and dividends received. An election is irrevocable without the consent of the Secretary or her delegates (Secretary).

The election is available to non-life insurance companies that receive during the taxable year, along with any member of the same controlled group of corporations, net written premiums (or, if greater, direct written premiums) that do not exceed the threshold amount for that year. The threshold amount for taxable years beginning after December 31, 2021, is \$2.45 million. This amount is indexed annually for inflation.

An electing insurance company must also meet at least one of two ownership diversification requirements. An insurance company meets the first diversification requirement if no more than 20 percent of its net written premiums (or, if greater, direct written premiums) is attributable to any one policyholder. For this purpose, all policyholders that are related (within the meaning of section 267(b) or 707(b) of the Internal Revenue Code, which generally include close family relationships, fiduciary relationships, and more-than-50 percent ownership of entities) or that are members of the same controlled group of corporations (using a more-than-50 percent control standard) are treated as a single 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.

Reasons for Change

The alternative tax regime is intended to allow electing insurance companies to provide more affordable insurance coverage to policyholders. However, some taxpayers have worked with promoters to abuse the alternative regime to benefit themselves or related parties without providing insurance (or by providing minimal insurance for exorbitant prices). In these cases, taxpayers, or related parties, own both an electing entity characterized as an insurance company and one or more businesses paying amounts characterized as insurance premiums to the electing entity. Each business purchasing a policy from the electing entity claims tax deductions for the amounts paid and characterized as premiums. The electing entity, however, does not include these amounts in gross income and does not deduct any underwriting costs (insurance claims and

associated expenses) in computing its taxable income. In many cases identified in audit by the IRS, the arrangements characterized as insurance do not satisfy the requirements for insurance contracts under Federal income tax law. In addition, the amounts characterized as insurance premiums in these cases are unreasonably high, resulting in large amounts of untaxed underwriting income that are not needed to pay policyholder claims and related expenses. In these cases, the electing entity often uses these funds for purposes unrelated to the business of insurance, such as making loans to, or purchases for, the personal or business use of related persons, including policyholders. These fact patterns are more likely if related parties own both the electing entity and the entities paying the amounts characterized as premiums and if a significant portion of the electing entity's net written premiums are attributable to a single policyholder or small number of related policyholders. While the U.S. Tax Court, in several recent decisions, has determined that certain fact patterns with these attributes do not represent insurance transactions and has denied the claimed deductions (and, in some cases, imposed penalties or required the electing entity to include the alleged premiums in income), auditing and litigating such arrangements consumes significant scarce tax administration resources.²⁷

Proposal

The proposal would curtail abuse by certain electing companies while preserving the alternative tax election for those companies that use this tax benefit to reduce the cost of insurance. The proposal would achieve this goal by requiring certain electing insurance companies (covered insurance companies) to establish an Untaxed Income Account (UIA). Certain amounts ("deemed distribution") would be deemed to be paid from the UIA to the extent that the UIA has a positive balance and would be subjected to corporate income tax and a penalty.

An electing insurance company would be a covered insurance company beginning in the earliest taxable year occurring after the proposal's effective date in which the electing company fails to meet the first diversification requirement described above (that is, the first year in which the electing company has more than 20 percent of its net written premiums, or, if greater, direct written premiums, for the taxable year attributable to any one policyholder or a group of related taxpayers).

Untaxed income (or loss) of a covered insurance company would be defined as the taxable income (or net operating loss) of the company, determined as if the company were taxed as a non-electing insurance company but without regard to the deduction for net operating loss carrybacks or carryovers, less the company's taxable investment income or loss. The untaxed income (or loss) of a covered insurance company for the taxable year would be added to its UIA as determined at the end of the prior taxable year to yield an unadjusted UIA for the current taxable year. The amount of the insurer's unadjusted UIA could be negative.

The sum of shareholder distributions, share repurchases, and any payments that are not ordinary and necessary costs incurred for the conduct of an insurance business would be deemed an

²⁷ See, for example, *Avrahami v. Commissioner*, 149 T.C. 144 (2017); *Caylor Land & Development, Inc. v. Commissioner*, T.C. Memo. 2021-30 (2021) (accuracy related penalty also sustained); and *Szygy Ins. Co., Inc. v. Commissioner*, T.C. Memo 2019-34 (2019) (company also required to recognize the premiums it received as income).

unadjusted net distribution from the covered company's unadjusted UIA. A payment that is not an ordinary and necessary cost incurred for the conduct of an insurance business would include any payment or loan made to a related party other than a payment that is (a) a payment to satisfy a covered insurance (including reinsurance) loss, (b) a payment of a return premium or consideration paid for reinsurance, or (c) a payment for ordinary and necessary business expenses of the insurance company. For this purpose, a related party would be a person that is related (within the meaning of sections 267(b) or 707(b)) to an owner of the insurance company or to an insured or beneficiary of a contract issued by the insurance company or is a member of the same controlled group of corporations (using a more-than-50 percent control standard) as the insurance company.

The unadjusted net deemed distribution, described above, would be grossed up by dividing it by a tax factor equal to one less the sum of the highest corporate marginal tax rate and a penalty tax rate of 10 percent. For example, if the highest corporate tax rate were 28 percent, the rate of tax on deemed UIA distributions would be 38 percent. However, this gross deemed distribution from the UIA would be limited to the amount of the unadjusted UIA (or zero, if the unadjusted UIA were a negative amount). The covered company's UIA for the taxable year would equal its unadjusted UIA less the amount of its (possibly limited) gross deemed distribution. Tax would be assessed on the covered company's (possibly limited) gross deemed distribution using the sum of the corporate and penalty tax rates embedded in the gross-up tax factor (38 percent under proposed rules) and would be added to the company's regular tax determined using its taxable investment income to yield the covered insurance company's total income tax for the taxable year. Distributions or other payments not deemed to be from the company's UIA would be treated according to generally applicable tax rules.

The rules deeming distributions from a covered insurance company's UIA would continue to apply in taxable years after the company ceases to be subject to the alternative tax regime. Such a company could cease being subject to these rules by electing to deem an amount distributed from its positive unadjusted UIA sufficient to achieve a zero UIA balance at the end of the taxable year, obtaining the consent of the Secretary, and paying the appropriate amount of additional tax with respect to that deemed distribution. Similarly, a company that is a covered insurance company, but which now satisfies the first diversification requirement, could cease to be classified as a covered insurance company by making a similar deemed distribution from its positive unadjusted UIA, obtaining the consent of the Secretary, and paying the appropriate amount of additional tax. Similar rules requiring the payment of additional tax would apply upon liquidation or reorganization of a covered insurance company and to certain other transactions (for example, if a foreign insurance company that elected domestic treatment ceases to qualify for that election or reorganizes as a non-electing foreign entity). The Secretary would be authorized to prescribe regulations preventing the avoidance of the UIA taxation rules through conduit arrangements, accommodation parties, or otherwise.

It is recognized that further measures might be needed to limit the ability of covered insurance companies to retain untaxed income indefinitely, and consideration should be given to additional rules to limit that ability. One such measure could provide that any addition to a UIA that remains in the UIA after a specified period of time (for example, ten years) would be treated as a

deemed payment from the UIA at that point. Such a rule would require an additional first-in-first-out ordering rule regarding additions to and distributions from a company's UIA.

The proposal would be effective for distributions, sales, and other transactions that occur in taxable years of a covered insurance company beginning after December 31, 2022.

EXPAND PRO RATA INTEREST EXPENSE DISALLOWANCE FOR BUSINESS-OWNED LIFE INSURANCE

Current Law

In general, no Federal income tax is imposed concurrently on a policyholder with respect to the earnings credited under a life insurance or endowment contract. Furthermore, amounts received under a life insurance contract by reason of the death of the insured generally are excluded from gross income of the recipient. Federal income tax generally is deferred with respect to earnings under an annuity contract unless the annuity contract is owned by a person other than a natural person.

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 percent 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.

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. The provision does not apply to a policy or contract held by a natural person unless the business (other than a sole proprietorship) is directly or indirectly a beneficiary under the policy, nor does it apply to annuity contracts not held by natural persons, the income of which is subject to current taxation. The provision generally applies before interest expense is capitalized into the cost of produced property under the uniform capitalization rules of the Internal Revenue Code (Code) but generally after other limitations on interest deductions are imposed. An exception to the pro rata interest-disallowance rule applies with respect to contracts that cover individuals who were officers, directors, employees, or 20 percent 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.

Insurance companies are excepted from the interest allocation rule. Instead, they are subjected to special proration rules that require taxable income adjustments to prevent or limit the funding of tax-deductible reserve increases with tax-preferred income, including earnings credited under life insurance, endowment, and annuity contracts.

Reasons for Change

Certain interest disallowance provisions of the Code are intended to deny a deduction for the cost of earning gross income when that income is not taxed. However, in the current instance, the Code allows certain exceptions to this principle that are overly broad and should be narrowed. In particular, if debt is directly traceable to an insurance contract covering the life of a current officer or 20 percent owner of the business, then interest expense may be deductible, although, in this case, the number of such excepted contracts is limited, and the amount of deductible interest may be limited. However, the exceptions are broader in the case where an entity's interest expense is generally allocated to insurance contracts under a pro rata rule. Here, excepted contracts are those covering the lives of both past and current employees and directors, in addition to past and current officers and 20 percent owners, with no limit on the numbers of insured lives. The proposal would narrow this loophole and better ensure that interest deductions are limited when generating non-taxed income.

Proposal

The proposal would repeal the exception from the pro rata interest expense disallowance rule for contracts covering employees, officers, or directors. The exception for a policy covering a 20 percent owner of a business would remain.

The proposal would apply to contracts issued after December 31, 2021. For this purpose, a material increase in the death benefit or other material change in an existing contract would be treated as the issuance of a new contract, except that in the case of a master contract, the addition of covered lives would be treated as the issuance of a new contract only with respect to the additional covered lives.

CORRECT DRAFTING ERRORS IN THE TAXATION OF INSURANCE COMPANIES UNDER THE TAX CUTS AND JOBS ACT OF 2017

Current Law

The Tax Cuts and Jobs Act of 2017 (TCJA) contains two drafting errors related to the taxation of insurance companies.

Policy acquisition costs

Insurance companies must capitalize, as policy acquisition expenses, a portion of their general deductions otherwise allowed. These capitalized amounts are generally amortized over 180 months, although up to \$5 million of such costs may be amortized over 60 months. This \$5 million amount is reduced to the extent an insurer has annual policy acquisition costs in excess of \$10 million. Capitalized policy acquisition costs generally equal a percentage of an insurer's net premiums on specified contracts. Prior to TCJA, these percentages equaled 1.75 percent of net premiums received on annuity contracts, 2.05 percent of net premiums received on group life insurance contracts, and 7.70 percent of net premiums received on other life insurance or noncancellable accident and health insurance contracts. In the TCJA, Congress not only extended the general amortization period for future capitalized amounts from 120 months to 180 months but attempted to increase the capitalization percentages to 2.09 percent for annuity contracts, 2.45 percent for group life insurance contracts, and 9.20 percent for other specified contracts, effective for taxable years beginning in 2018. These changes represent approximately a 19.5 percent increase in capitalized amounts for each of the three contract categories. A statutory drafting error, however, misidentified the appropriate language in the Internal Revenue Code (Code), so that only the percentage for annuity contracts could be implemented logically. Consequently, a reasonable reading of the law could claim that only the percentage for annuity contracts was changed by TCJA, despite the intent of Congress identified in the statute's legislative history.

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 have relatively short payout profiles. These lines of business include, for example, auto physical damage, warranty insurance, financial guarantee insurance, and certain special property lines of business. 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 – currently, 18 years in the case of workers' compensation claims. 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 (NAIC) 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, mainly by establishing a different method for determining the applicable interest rates and by lengthening the expected claim payment patterns for long-tail lines of business. However, in modifying the Code to enact these changes, the drafters 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 must be treated as short-tail lines of business, and Treasury regulations now consider them as such – even though there is no legislative history to indicate that this change was intended by Congress.

Reasons for Change

The TCJA intended to align the capitalization and amortization requirements of the Code to the economic realities of the market. This required greater capitalization percentages and a longer amortization period. The drafting errors of the TCJA, however, cast doubt on whether actual law represented the intended changes. While preliminary analysis of post-TCJA tax data shows the vast majority of companies have been capitalizing amounts consistent with the described intent of the TCJA, this does not appear to reflect the opinion of all taxpayers. Correcting this error would restore certainty in the application of the tax law and result in a more even tax treatment of similar taxpayers.

The TCJA drafting error regarding the discounting of unpaid losses has had relatively minor consequences for aggregate revenue. However, the error treats the international and nonproportional reinsurance lines of business more favorably than other lines of business with similar loss payment periods by inappropriately reducing the degree of discount for unpaid losses. It has therefore provided these types of insurance and reinsurance with an unwarranted and unintended deferral of income recognition.

Proposal

The proposal would make two required technical corrections to these statutory drafting errors in the TCJA:

The first correction would change the capitalization rate of net premiums for group life insurance contracts from 2.05 percent to 2.45 percent and the capitalization rate for other non-annuity specified life and health contracts from 7.70 percent to 9.20 percent. The 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 taxable year beginning in 2022.

A second technical correction 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. The proposal would be effective for taxable years beginning after December 31, 2022. 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

Current Law

If any diesel fuel or kerosene is exported, the IRS is required to pay to the “ultimate purchaser” of the diesel fuel or kerosene a rebate of any Federal excise taxes previously collected on that diesel fuel or kerosene. The term “ultimate purchaser” is not defined in the Internal Revenue Code. Under current law, it is possible in some circumstances for both the foreign national end user of the diesel fuel or kerosene and the last purchaser within the United States that exports the diesel fuel or kerosene to qualify as the ultimate purchaser for this purpose.

Reasons for Change

The ability of more than one person to qualify as the ultimate purchaser results in cases where the IRS is required to pay as a rebate of twice the amount of Federal excise taxes collected on exported diesel fuel or kerosene.

Proposal

The proposal would define the person entitled to a rebate of Federal excise taxes as the last purchaser in the United States for the purposes of diesel fuel and kerosene exportation.

The proposal would be effective for diesel fuel and kerosene exported after December 31, 2022.

IMPROVE TAX ADMINISTRATION AND COMPLIANCE

ENHANCE ACCURACY OF TAX INFORMATION

Current Law

Electronic filing of forms and returns

Generally, the Secretary or her delegates (Secretary) may issue regulations that require electronic filing of returns (as opposed to paper filing of returns) if the taxpayer files a minimum number of returns during a year. For example, corporations that have assets of \$10 million or more and file at least 250 returns of any type during a calendar year are required to file electronically their Form 1120/1120S, U.S. Corporation Income Tax Return. Partnerships with more than 100 partners are required to file electronically, regardless of how many returns they file.

Before requiring electronic filing, the IRS and the Treasury are generally required to take into account the ability of taxpayers to comply at a reasonable cost. Taxpayers may request waivers of the electronic filing requirement if they cannot meet that requirement due to technological constraints, or if compliance with the requirement would result in undue financial burden on the taxpayer. In general, the Secretary may not require individuals, estates, and trusts to file their income tax returns electronically.

Reportable payments subject to backup withholding

Backup withholding applies to a reportable payment if a payee fails to furnish the payee's taxpayer identification number (TIN) to the payor in the manner required. Currently, the IRS may only require that the payee furnish the TIN under penalties of perjury with respect to interest, dividends, patronage dividends, and amounts subject to broker reporting. Accordingly, payees of these reportable payments are generally required to provide payors with a certified TIN using a Form W-9, Request for Taxpayer Identification Number and Certification, under penalties of perjury. Payees of other reportable payments subject to backup withholding may furnish their TINs in other ways, including orally, unless the IRS has notified a payor that the TIN furnished is incorrect. This applies to payments under sections 6041, 6041A, 6050A, 6050N, and 6050W of the Internal Revenue Code.

Reasons for Change

Facilitating more accurate tax information supports the broader goals of improving IRS service to taxpayers, enhancing compliance, and modernizing tax administration.

Expanding electronic filing will help provide tax return information to the IRS in a more uniform electronic form, which will enhance the ability of the IRS to better target its audit activities. This in turn can reduce burdens on compliant taxpayers by decreasing the probability that they will be among those selected for audit. Consequently, increased electronic filing of returns may improve satisfaction and confidence in the filing process. The proposal would provide the Secretary

broader authority to require electronic filing that would facilitate the IRS's compliance risk assessment process and allow for more efficient tax administration, particularly with respect to large or complex business entities and certain types of transactions that may warrant greater scrutiny.

The intent of backup withholding is to serve as an enforcement tool in ensuring payors and payees are compliant with their reporting obligations. Requiring payees to certify their TINs to payors on a Form W-9 or equivalent form reduces the level of enforcement necessary to ensure information is accurate. Information reporting increases compliance by providing taxpayers with the information that they need to accurately complete their tax returns and by providing the IRS with information that can be used to verify taxpayer compliance. Without accurate taxpayer identifying information, information reporting requirements impose avoidable burdens on businesses and the IRS, and they cannot reach their potential to improve compliance.

Proposal

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

Electronic filing would be required for returns filed by taxpayers reporting larger amounts or that are complex business entities, including: (a) income tax returns of individuals with gross income of \$400,000 or more; (b) 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; (c) partnership returns for partnerships with assets or any item of income of more than \$10 million in any of the three preceding years; (d) partnership returns for partnerships with more than 10 partners; (e) returns of real estate investment trusts (REITs), real estate mortgage investment conduits (REMICs), regulated investment companies (RICs), and all insurance companies; and (f) corporate returns for corporations with \$10 million or more in assets or more than 10 shareholders. Further, electronic filing would be required for the following forms: (a) Form 8918, Material Advisor Disclosure Statement; (b) Form 8886, Reportable Transaction Disclosure Statement; (c) Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons; (d) Form 8038-CP, Return for Credit Payments to Issuers of Qualified Bonds; and (e) Form 8300, Report of Cash Payments Over \$10,000 Received in a Trade or Business.

Return preparers that expect to prepare more than 10 corporation income tax returns or partnership returns would be required to file such returns electronically.

The Secretary would also be authorized to determine which additional returns, Statements, and other documents must be filed in electronic form in order to ensure the efficient administration of the internal revenue laws without regard to the number of returns that a person files during a year.

Improve information reporting for reportable payments subject to backup withholding

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, 2022.

ADDRESS TAXPAYER NONCOMPLIANCE WITH LISTED TRANSACTIONS

Current Law

Generally, the IRS must assess a tax within three years after the date the return is filed, subject to several exceptions. A special rule applies if a taxpayer fails to include on any return or Statement information that is required with respect to a listed transaction. A listed transaction means a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary or her delegates (Secretary) as a tax avoidance transaction. The period for assessment of tax with respect to a listed transaction does not expire before one year after the earlier of the date the required information is furnished to the Secretary or the date that a material advisor makes the required disclosure.

The Treasury and IRS have identified Intermediary Transaction Tax Shelters as listed transactions that require disclosure on a tax return to avoid certain penalties. These transactions typically involve a sale of a controlling interest in the stock of a C corporation to another entity (an intermediary entity) that is undertaken as part of a plan to cause the C corporation to recognize income or gain from the sale of its assets shortly before or shortly after the sale of the C corporation's stock.

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' ability to collect taxes that are legally owed.

The transaction may yield the selling shareholders a higher sales price for their C corporation stock than could be supported if the corporate income tax liability were to be paid. However, outside of the consolidated return context, former shareholders of a C corporation generally are not liable for any unpaid income taxes, interest, additions to tax, or penalties owed by the C corporation.

Reasons for Change

Despite such transactions being identified by the IRS as listed transactions since 2001, shareholders, corporate officers, directors, and their advisors have continued to engage in Intermediary Transaction Tax Shelters or substantially similar transactions. Because the unpaid Federal tax evaded through these transactions is reflected in the price paid for the corporation's stock, either the buyer or the seller could be liable for such unpaid amounts. Although the Federal government generally has adequate tools under current law to collect amounts from the buyer or its lenders, these parties typically do not have assets in the United States against which the IRS can proceed to collect the unpaid taxes. The selling shareholders are typically the only parties with sufficient assets in the United States against which the IRS could proceed for collection; however, it has proven difficult for the IRS to effectively collect the unpaid Federal

taxes from these selling shareholders under current law. Even though the IRS has pursued litigation to enforce collection from the selling shareholders of several corporations, these actions have yielded mixed results in factually similar cases. Thus, existing law does not adequately protect the Federal government's interest in collecting the amounts due from selling shareholders as a result of these transactions.

In addition, additional time is needed for the IRS to conduct examinations and assess taxes in connection with listed transactions, which may be complex in nature and require a thorough examination of the relevant facts.

Proposal

Extend statute of limitations for listed transactions

The proposal would increase the limitations period under section 6501(a) of the Internal Revenue Code (Code) for returns reporting benefits from listed transactions from three years to six years. The proposal also would increase the limitations period for listed transactions under section 6501(c)(10) from one year to three years. This proposed change would be effective on the date of enactment.

Impose liability on shareholders to collect unpaid income taxes of applicable corporations

The proposal would also add a new section to the Code that would impose on shareholders who sell the stock of an "applicable C corporation" secondary liability (without resort to any State law) for payment of the applicable C corporation's income taxes, interest, additions to tax, and penalties to the extent of the sales proceeds received by the shareholders. The proposal applies to shareholders who, directly or indirectly, dispose of a controlling interest (at least 50 percent) in the stock of an applicable C corporation within a 12-month period in exchange for consideration other than stock issued by the acquirer of the applicable C corporation stock. The secondary liability would arise only after the applicable C corporation was assessed income taxes, interest, additions to tax, and penalties with respect to any taxable year within the 12-month period before or after the date that its stock was disposed of and the applicable C corporation did not pay such amounts within 180 days after assessment.

For purposes of the proposal, an applicable C corporation is any C corporation (or successor) two thirds or more of whose assets consist 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 a controlling interest in its stock is sold. The proposal would grant the Secretary authority to prescribe regulations necessary or appropriate to carry out the proposal.

The proposal would not apply with respect to dispositions of a controlling interest (a) in the stock of a C corporation or real estate investment trust with shares traded on an established securities market in the United States, (b) in the shares of a regulated investment company that offers shares to the public, or (c) to an acquirer whose stock or securities are publicly traded on an established market in the United States, or is consolidated for financial reporting purposes with such a public issuer of stock or securities.

The proposal would close the taxable year of an applicable C corporation as of the later of a disposition of a controlling interest in its stock or a disposition of all of its assets. The proposal would also amend the Code to provide that the amount that the selling shareholder was secondarily liable for under this proposal would constitute a deficiency that was governed by the general notice and demand rules of the Code but with an additional year added to the statute of limitations for assessment. The proposal would not limit the government's ability to pursue any cause of action available under current law against any person.

The proposed changes above would be effective for sales of controlling interests in the stock of applicable C corporations occurring on or after April 10, 2014.

AMEND THE CENTRALIZED PARTNERSHIP AUDIT REGIME TO PERMIT THE CARRYOVER OF A REDUCTION IN TAX THAT EXCEEDS A PARTNER'S TAX LIABILITY

Current Law

Section 6226 of the Internal Revenue Code (Code) requires reviewed year partners to include in their reporting year taxes an amount equal to the change in tax that would have occurred for the reviewed year (the taxable year under audit) and all years between the reviewed year and the reporting year if the partnership adjustments were taken into account by the partners in those taxable years. The statutory formula provides, however, that for each of those years, the partners take into account the changes in tax liability that would have occurred in those years by increasing or decreasing their tax liability on their reporting year return by the sum of those changes in tax. If the calculation results in a net decrease, 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. 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.

Reasons for Change

The inability for reviewed year partners to receive the full benefit of any reductions in tax as a result of 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 the partner would have outside of the centralized partnership audit regime.

Proposal

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

The proposal would be effective on the date of enactment.

INCORPORATE CHAPTERS 2/2A IN CENTRALIZED PARTNERSHIP AUDIT REGIME PROCEEDINGS

Current Law

The centralized partnership audit regime, as enacted by the Bipartisan Budget Act of 2015 (BBA), currently separates the treatment of Chapters 1 (income tax) and 2/2A (self-employment income tax/net investment income tax) adjustments for reporting, tax calculation, and assessment purposes. This disparate treatment requires taxpayers to file multiple tax returns to meet their filing obligations and/or requires the IRS to apply dual proceedings to meet its enforcement obligations.

Partnerships report their income on Form 1065, U.S. Return of Partnership Income, in an overall manner and allocate that income to their partners on Schedules K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, etc., separately stating income amounts subject to Chapters 1 and 2/2A. The calculations of tax liability under these three chapters are intrinsically linked, and individual partners, including partners in partnerships that are subject to the BBA, calculate and pay their taxes under these three chapters in one filing: Form 1040, U.S. Individual Income Tax Return. A BBA proceeding requires the IRS to address adjustments impacting the Chapter 1 liability of any person at the partnership level, meaning the IRS must follow centralized BBA rules and generally assess and collect from the partnership an imputed underpayment amount with respect to such adjustments that would increase the taxable income of its 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.

Reasons for Change

Cumbersome procedures that link impacted partners' returns to a BBA return under examination in addition to administering the BBA proceeding are contrary to the intent that BBA streamline tax administration of partnership examinations. Essentially, the partners' returns are also required to be examined. For partnerships that file Administrative Adjustment Requests, make Amended Return Modification elections, or make Push-Out elections, partners must separately amend their reviewed-year Forms 1040 to pay any Chapter 2/2A taxes attributable to the adjustments made in the partnership proceeding.

Proposal

The proposal would amend the definition of a BBA Partnership-Related-Item to include items that affect a person's Chapter 2/2A taxes and would apply the highest rate of tax in effect for the reviewed year under section 1401 or 1411 of the Internal Revenue Code to these items.

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

AUTHORIZE LIMITED SHARING OF BUSINESS TAX RETURN INFORMATION TO MEASURE THE ECONOMY MORE ACCURATELY

Current Law

Current law authorizes the IRS to disclose certain Federal Tax Information (FTI) for governmental statistical use. Business FTI may be disclosed to officers and employees of the Census Bureau for all businesses. Similarly, business FTI may be disclosed to officers and employees of the Bureau of Economic Analysis (BEA), but only for corporate businesses. Specific items permitted to be disclosed are detailed in the associated Treasury Regulations. The Bureau of Labor Statistics (BLS) is currently not authorized to receive FTI.

Reasons for Change

BEA's limited access to business FTI and BLS's lack of access to business FTI prevents BEA, BLS, and Census Bureau from synchronizing their business lists. Synchronization of business lists would significantly improve the consistency and quality of sensitive economic statistics including productivity, payroll, employment, and average hourly earnings.

In addition, given the growth of non-corporate businesses, especially in the service sector, the current limitation on BEA's access to corporate FTI impedes the measurement of income and international transactions in the National Accounts. The accuracy and consistency of income data are important to the formulation of fiscal policies.

Further, the Census Bureau's Business Register is constructed using both FTI and non-tax business data derived from the Economic Census and current economic surveys. Because this non-tax business data is inextricably comingled with FTI, it is not possible for the Census Bureau to share data with BEA and BLS in any meaningful way.

Proposal

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. BEA contractors would not have access to FTI.

The proposal would also give BLS officers and employees access to certain business (and tax-exempt entities) FTI including: Taxpayer Identification Number (TIN); name(s) of the business; business address (mailing address and physical location); principal industry activity (including business description); number of employees and total business-level wages (including wages, tips, and other compensation, quarterly from Form 941, Employer's Quarterly Federal Tax Return, and annually from Form 943, Employer's Annual Federal Return for Agricultural Employees, and Form 944, Employer's Annual Federal Tax Return); and sales revenue for employer businesses only. BLS would not have access to individual employee FTI. In other words, the proposal would allow officers and employees of each of BLS, BEA, and the Census Bureau to access the same FTI for businesses, and would permit BLS, BEA, and the Census Bureau to share such FTI amongst themselves (subject to the restrictions described below).

For the purpose of synchronizing BLS and Census Bureau business lists, the proposal would permit employees of State agencies to receive from BLS the following FTI identity items: TIN, business name(s), business address(es), and principal industry activity (including business description). No BLS contractor or State agency contractor would have access to FTI.

The proposal would require any FTI to which BEA and BLS would have access, either directly from the 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 three statistical agencies and State agencies would be subject to taxpayer privacy law, safeguards, and penalties. They would also be subject to CIPSEA confidentiality safeguard procedures, requirements, and penalties. Conforming amendments to applicable statutes would be made as necessary to apply the taxpayer privacy law, including safeguards and penalties to BLS as well as the Census Bureau and BEA. BLS would be required to monitor compliance by State agencies with the prescribed safeguard protocols.

The proposal would be effective on the date of enactment.

IMPOSE AN AFFIRMATIVE REQUIREMENT TO DISCLOSE A POSITION CONTRARY TO A REGULATION

Current Law

Section 6662(b)(1) of the Internal Revenue Code imposes a 20 percent accuracy-related penalty on underpayments attributable to 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. This exception applies on a case-by-case basis and requires consideration of all relevant facts and circumstances, including whether the taxpayer reasonably relied in good faith on the opinion or advice of a professional tax advisor. However, a taxpayer cannot rely on a tax advisor's opinion that a regulation is invalid to establish reasonable cause and good faith if the taxpayer did not adequately disclose the position.

Reasons for Change

Current law treats the disclosure of a position contrary to a regulation as a means to avoid imposition of the accuracy-related penalty. There is, however, no affirmative obligation for taxpayers to inform the IRS that they are taking such a position.

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. Such positions are difficult for the IRS to identify if the taxpayer chooses not to disclose them for penalty protection purposes. Some taxpayers have eschewed penalty protection by forgoing the disclosure of positions that are contrary to a regulation in the hopes of avoiding scrutiny.

Proposal

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 fails to make the required disclosure would be subject to an assessable penalty that is 75 percent of the decrease in tax shown on the return as a result of the position. Such penalty shall not be less than \$10,000 or more than \$200,000, adjusted for inflation. The penalty would not apply, for example, if a taxpayer reasonably and in good faith believed that its position is consistent with the regulation. 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.

REQUIRE EMPLOYERS TO WITHHOLD TAX ON FAILED NONQUALIFIED DEFERRED COMPENSATION PLANS

Current Law

A nonqualified deferred compensation (NQDC) arrangement is a plan or agreement between an employer and an employee (or a service recipient and service provider) to pay the employee compensation at retirement or another specified future date. An employee generally does not recognize NQDC income and owe tax on that income until the compensation is received, provided the NQDC arrangement satisfies specific tax requirements.

Under the tax rules, a NQDC arrangement must comply with election and distribution timing requirements that are designed to prevent taxpayers from manipulating the timing of the recognition of income. If a NQDC arrangement fails to comply with these requirements, then the employee must include vested NQDC in income currently and is subject to a 20 percent additional tax and, in some circumstances, an additional interest tax.

Employers are required to withhold Federal income tax from employee's compensation based on the regular income tax rates. However, employers are not required to withhold the 20 percent additional tax or additional interest tax in the case of a NQDC arrangement that fails to comply with the tax requirements.

Reasons for Change

IRS employment tax examiners can assess the regular Federal income tax withholding on an employer through an employment tax examination of the employer. However, the IRS examiners are unable to collect the 20 percent additional tax or additional interest tax on NQDC that fails to comply with tax requirements from employers that maintain the failed NQDC arrangements. Instead, in the case of NQDC that fails to satisfy the tax requirements, the IRS examiner must assess the employee for the 20 percent additional tax and the additional interest tax. Initiating exams of each employee for these additional taxes is time-consuming, administratively impractical, burdensome, and an inefficient use of IRS resources.

Proposal

The proposal would require employers to withhold the 20 percent additional tax and additional interest tax on the NQDC included in an employee's income due to the NQDC arrangement failing to comply with the tax requirements. Section 3402(a) of the Internal Revenue Code (Code) would be amended to include the 20 percent additional tax and the additional tax imposed by section 409A(a)(1)(B) of the Code.

The proposal would be effective after December 31, 2022.

EXTEND TO SIX YEARS THE STATUTE OF LIMITATIONS FOR CERTAIN TAX ASSESSMENTS

Current Law

Section 6501 of the Internal Revenue Code (Code) generally requires the IRS to assess a tax within three years after the filing of a return, subject to several exceptions. For example, section 6501(c)(1) provides that there are no time limitations on the assessment of tax arising from a false or fraudulent return; section 6501(e)(1)(A) provides a six-year limitations period where there is a substantial omission of gross income on a taxpayer's return; and section 6501(e)(1)(C) applies a six-year limitations period if a taxpayer omits amounts that must be included in income under the subpart F rules.

Reasons for Change

Complex audits in the largest cases require extensive factual development by multidisciplinary teams of revenue agents, tax law specialists, economists, engineers, and other IRS personnel. Critical issues may not be identified until late in the process of an examination, and in many cases further development often cannot be pursued due to time and resource constraints, including the three-year statute of limitations. Although taxpayers will typically consent to extend their statutes of limitations, those consents may be subject to negotiations between the IRS and taxpayers and the resulting consents may be limited to particular issues and for insufficient lengths of time. Extending the statute of limitations for complex cases would provide the IRS with enhanced agility and flexibility in evaluating and staffing its case inventory and appropriately allocating its limited enforcement resources. These considerations are especially acute for cases requiring the assistance of transfer pricing economists, as well as for cases involving the application of recently enacted statutory provisions to complex cross-border transactions.

Proposal

The proposal would amend section 6501 to provide a six-year statute of limitations if a taxpayer omits from gross income more than \$100 million on a return.

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

EXPAND AND INCREASE PENALTIES FOR NONCOMPLIANT RETURN PREPARATION AND E-FILING AND AUTHORIZE IRS OVERSIGHT OF PAID PREPARERS

Current Law

Penalties for return preparation and e-filing

Many taxpayers rely on paid tax return preparers to prepare their tax returns and refund claims each year. Paid tax return preparers are subject to statutory return preparation standards. Such obligations include making certain disclosures and taking certain actions with respect to returns they prepare. For example, by law, anyone who is paid to prepare or assists in preparing Federal tax returns must identify themselves on those returns by using the prescribed identifying number. Under the applicable regulations, that number is a valid Preparer Tax Identification Number (PTIN). Paid tax return preparers must sign and include their PTIN on the return.

Civil penalties and injunctive relief may be used to address preparer noncompliance. For example, civil penalties apply to tax preparers who fail to report all of the taxpayer's income on the return that results in understatement of the taxpayer's liability as well as tax preparers who fail to follow rules and regulations when preparing a tax return. These penalties generally must be assessed within three years after the return is filed. The penalties and their amounts under current law are listed below in the table after the description of the proposal.

In addition, many taxpayers rely on e-file providers to electronically originate and transmit their returns to the IRS. 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), which is required to electronically file tax returns. There is no civil penalty on e-file provider misconduct.

IRS oversight of paid preparers

Under U.S. Code Title 31 (Money and Finance), Section 330 – Practice before the Department, the Secretary has the authority to regulate practice before the IRS. Regulations under that section, referred to as “Circular 230,” regulate the practice of licensed attorneys, certified public accountants, and enrolled agents and actuaries. In 2009, in response to concerns about the lack of regulation of unlicensed and unenrolled paid tax return preparers, the IRS conducted a formal review of its regulation of paid tax return preparers. After significant consideration and input from taxpayers, tax professionals, and other stakeholders, Treasury and the IRS amended Circular 230 to regulate practice of all paid tax return preparers, including individuals who are unlicensed and unenrolled. Paid tax return preparers challenged these regulations in *Loving v. Commissioner*. The Court of Appeals for the District of Columbia Circuit determined that these regulations exceeded the IRS's authority in 2014.²⁸

²⁸ See *Loving v. Commissioner*, 742 F.3d 1013 (D.C. Cir. 2014).

Reasons for Change

Expand and increase penalties for return preparation and e-filing

Inappropriate behavior by paid tax return preparers harms taxpayers through the filing of inaccurate returns, erroneous refunds and credits, and personal tax return noncompliance. It may also diminish public confidence in the tax system, which relies on the public's cooperation. Despite the penalties that may apply to paid tax return preparers, tax-return-preparer misconduct has continued, in part, because the amounts of the penalties under current law do not adequately promote voluntary compliance.

Furthermore, it is time-consuming for the IRS to identify and investigate paid return preparers who fail to include a valid identification number on returns they prepare, generally referred to as "ghost preparers." These preparers may be: (a) attempting to avoid IRS scrutiny of positions taken on the return; (b) already subject to a compliance action or under a Federal court order barring them from further return preparation; or (c) underreporting their own income from tax preparation, thereby increasing the tax gap. Allowing additional time for the IRS's investigation will increase the effectiveness of the applicable preparer penalty. A new penalty for failure by a taxpayer to disclose the use of a paid tax return preparer will discourage reliance on incompetent and dishonest tax return preparers and promote compliance. With this disclosure, IRS will be better positioned to identify preparers perpetuating fraud that harms taxpayers.

Although e-file providers must pass an initial suitability check to receive an EFIN, there have been instances of e-file providers improperly allowing unauthorized persons to use their EFIN to engage in electronic filing. Additional authority, including new penalties, is needed to regulate the conduct and suitability of e-file providers to prevent such abuse.

Grant authority to IRS for oversight of paid preparers

Paid tax return preparers have an important role in tax administration because they assist taxpayers in complying with their obligations under the tax laws. Incompetent and dishonest 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 tax preparers results in greater non-compliance when taxpayers who use incompetent preparers or preparers who engage in unscrupulous conduct become subject to penalties, interest, or avoidable costs of litigation due to the poor-quality advice they receive. The lack of authority affects revenues to the IRS when the resulting noncompliance is not mitigated 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.

Proposal

Expand and increase penalties for return preparation and e-filing

The proposal would 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.

The proposal would also 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.

The proposal would increase the limitations period during which the penalty for a failure to furnish the preparer's identifying number may be assessed from three years to six years.

The proposal would also 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.

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

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

The penalties under current law and under the proposal are summarized in the table on the following page.

Grant authority to IRS for oversight of all paid preparers

The proposal would amend Title 31, U.S. Code (Money and Finance) to provide the Secretary with explicit authority to regulate all paid preparers of Federal tax returns, including by establishing mandatory minimum competency standards.

The proposal would be effective on the date of enactment.

SUMMARY OF SELECTED PENALTIES FACED BY PAID TAX RETURN PREPARERS FOR NONCOMPLIANCE

Calculation of Penalties

NONCOMPLIANT BEHAVIOR	CURRENT LAW		PROPOSAL	
1. UPDATED PENALTIES FOR UNDERSTATEMENT OF LIABILITY				
Understatement due to ...	Greater of \$X or X% of income derived by preparer with respect to return or claim			
unreasonable conduct	\$1,000 or 50%		\$5,000 or 50%	
willful or reckless conduct	\$5,000 or 75%		\$10,000 or 100%	
2. UPDATED PENALTIES FOR REASONS OTHER THAN UNDERSTATEMENT OF LIABILITY				
Failure to ...	Per Offence	Maximum ¹	Per Offence	Maximum ¹
furnish a copy of a return or a claim for refund to taxpayer	\$50	\$25,000	\$250	\$50,000
sign a copy of a return or a claim for refund	\$50	\$25,000	\$1,000	\$75,000
furnish preparer's identifying number	\$50	\$25,000	\$1,000	\$75,000
retain completed copy of prepared return or list of taxpayers for whom returns were prepared	\$50	\$25,000	\$250	\$50,000
file correct information returns identifying the return preparers employed by a person	\$50	\$25,000	\$250	\$50,000
refrain from endorsing or negotiating a check in respect of taxes	\$500	None	\$1,000	None
comply with certain due diligence requirements ²	\$500	None	\$1,500	None
3. NEW PENALTIES ON PREPARERS, E-FILE PROVIDERS, AND TAXPAYERS				
NONCOMPLIANT BEHAVIOR	Per Offence	Maximum ¹	Per Offence	Maximum ¹
Appropriation of ...				
a PTIN			\$1,000	\$75,000
an EFIN			\$250	None
Failure to disclose use of preparer and fees paid to preparer by taxpayer			\$500	None

¹ Maximum is annual maximum per calendar year.

² Taxpayers and the preparers they use must comply with the requirements of IRS Form 8867, Paid Preparer's Due Diligence Checklist for the Earned Income Credit, American Opportunity Tax Credit, Child Tax Credit (including the Additional Child Tax Credit and Credit for Other Dependents), and/or Head of Household Filing Status.

ADDRESS COMPLIANCE IN CONNECTION WITH TAX RESPONSIBILITIES OF EXPATRIATES

Current Law

An individual may become a U.S. citizen at birth either by being born in the United States (or in certain U.S. territories) or by having a parent who is a U.S. citizen. All U.S. citizens generally are subject to U.S. income taxation on their worldwide income, even if they reside abroad.

U.S. citizens that reside abroad also may be subject to tax in their country of residence. Potential double taxation is generally relieved in two ways. First, U.S. citizens can credit foreign taxes paid against their U.S. taxes due, with certain limitations. Second, U.S. individuals may exclude from their U.S. taxable income a certain amount of income earned from working outside the United States. U.S. citizens living abroad are also eligible for the same exclusions from gross income and deductions as other U.S. taxpayers, and therefore may have taxable income that is low enough that no income tax is due.

The Internal Revenue Code (Code) imposes special rules on certain individuals who relinquish their U.S. citizenship or cease to be lawful permanent residents of the United States (expatriates). Expatriates who are “covered expatriates” generally are required to pay a mark-to-market exit tax on a deemed disposition of their worldwide assets as of the day before their expatriation date.

An expatriate is a covered expatriate if he or she meets at least one of the following three tests: (a) has an average annual net income tax liability for the five taxable years preceding the year of expatriation that exceeds a specified amount that is adjusted for inflation (the tax liability test); (b) has a net worth of \$2 million or more as of the expatriation date (the net worth test); or (c) fails to certify, under penalty of perjury, compliance with all U.S. Federal tax obligations for the five taxable years preceding the taxable year that includes the expatriation date (the certification test).

The definition of covered expatriate includes a special rule for an expatriate who became at birth a citizen of both the United States and another country and, as of the expatriation date, continues to be a citizen of, and taxed as a resident of, such other country. Such an expatriate will be treated as not meeting the tax liability or net worth tests if he or she has been a resident of the United States for not more than 10 taxable years during the 15-taxable year period ending with the taxable year during which the expatriation occurs. However, such an expatriate remains subject to the certification test.

If a taxpayer renounces U.S. citizenship or abandons lawful permanent resident status, that taxpayer must file Form 8854, Initial and Annual Expatriation Statement, with their U.S. tax return to make the certification described in the preceding paragraph and provide information to determine whether the individual is subject to the exit tax (and to compute such tax, if applicable).

Generally, the IRS has three years from the date a return is filed to assess the tax. However, existing law extends the assessment statute of limitations in certain cases, such as when a

taxpayer fails to furnish required information returns relating to various international transactions or assets. In these cases, the statute of limitations does not expire until three years after the information required to be reported is provided. Existing law does not include Form 8854 as one of the information returns that would trigger an extended statute of limitations.

Under the Foreign Account Tax Compliance Act (FATCA) provisions of the Code, a foreign financial institution is required to collect certain information about U.S. persons who hold an account with the institution, including the person's U.S. taxpayer identification number (TIN). A foreign financial institution that fails to comply with these rules may be subject to U.S. withholding tax on certain U.S. source payments. Foreign financial institutions consequently routinely require an account holder who is a U.S. citizen to provide a TIN.

Reasons for Change

Form 8854 is critical to the IRS's ability to identify expatriating taxpayers. If a person expatriates but fails to include the form with his or her tax return, it is difficult for the IRS to identify such a failure, and consequently the IRS may not be aware that the person has expatriated. Although the IRS receives information on expatriating individuals from the Department of State or from the United States Citizenship and Immigration Service, the information is received after the expatriating act and does not include TINs, which means that it is more difficult and time-consuming for the IRS to match this information with taxpayer records. In the case of long-term permanent residents, many are not aware of the requirement to file Form 8854 when they surrender their green cards, and the IRS has no established methodology of identifying such cases. Because of these difficulties, the IRS may not discover that an individual has expatriated and failed to file Form 8854 until more than three years after the individual files his or her tax return for the year of expatriation. In these circumstances, unless the IRS proves fraud, the IRS may be barred from making any expatriation related tax assessments because the assessment statute of limitation on the taxpayer's tax return may have already expired. These cases can involve substantial amounts of foregone exit tax and related taxes, and high net wealth taxpayers can exploit the tax system by simply failing to file Form 8854 with their tax return.

Lower-income individuals who have spent most of their lives abroad may find complying with these rules difficult when attempting to expatriate. A dual citizen who has spent most of his or her life outside the United States will be considered a covered expatriate despite having relatively low income and assets if the individual does not certify to the IRS compliance with all U.S. Federal tax obligations for the five preceding taxable years. Some dual citizens who have spent most of their lives outside the United States may not have previously filed a U.S. tax return or obtained a TIN. Foreign financial institutions in some countries have threatened to close bank accounts of U.S. citizens who do not provide a TIN. U.S. citizens who are citizens and residents of foreign countries and have limited contacts with the United States may wish to expatriate, but in order to avoid being considered covered expatriates such individuals need to be able to certify that they are compliant with all U.S. Federal tax obligations for the five preceding taxable years. For taxpayers with modest incomes who have not been filing U.S. tax returns but have been filing tax returns and paying tax in their countries of residence, the cost and practical difficulties of certifying compliance with their U.S. Federal tax obligations may impede their ability to

satisfy the requirements for expatriation. For example, it may be difficult to find a U.S. tax advisor to prepare a U.S. tax return in the taxpayer's country of residence, and the cost of doing so may be significant for a lower-income taxpayer. If the taxpayer would not owe any U.S. tax, the benefit to the IRS of the filing of such tax returns is limited.

Proposal

First, the proposal would provide that, in the case where a taxpayer is required to provide IRS Form 8854 with his or her 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. This will create parity with the current statute of limitation rules for tax returns when other information returns relating to various international transactions or assets are required to be filed with the return. The proposal will reduce abuse and noncompliance with respect to high net wealth expatriates.

Second, the proposal will grant the Secretary and her delegates authority 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 that have a tax home outside the United States and satisfy other conditions that ensure that their contacts with the United States are limited, and whose income and assets are below a specified threshold. Evidence of limited contacts with the United States may include a demonstration that the taxpayer's primary residence has been outside the United States for an extended period. Evidence of the taxpayer's income and assets may include a foreign tax return, information about the value of property owned by the taxpayer and the taxpayer's sources of income, or information demonstrating that a certain amount of income earned from working outside the United States is excludable from U.S. tax. No inference would be intended that the evidence acceptable to the Secretary under this provision constitutes the filing of a U.S. tax return.

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

SIMPLIFY FOREIGN EXCHANGE GAIN OR LOSS RULES AND EXCHANGE RATE RULES FOR INDIVIDUALS

Current Law

Section 988 of the Internal Revenue Code provides rules for determining the timing, amount, character and source of foreign exchange gain or loss from foreign currency, foreign currency debt, certain foreign currency expenses or foreign currency derivatives (when the foreign currency is a nonfunctional currency for the taxpayer). These rules apply to individuals as well as to businesses.

These rules do not apply to any transaction that is a personal transaction. A personal transaction generally means any transaction entered into by an individual. Such transactions do not include those where expenses properly allocable to the transaction are deductible as trade or business expenses or are expenses for the production of income (subject to some exceptions).

In addition, no gain is recognized for Federal income tax purposes for personal transactions involving the disposition of foreign currency where the gain is \$200 or less. This exemption for gains of no more than \$200 was enacted in 1986.

When a U.S. individual earns income denominated in a foreign currency, the individual must translate such income into U.S. dollars at the spot rate when earned. This includes U.S. individuals living and working abroad that regularly earn income in foreign currency.

Reasons for Change

Under current law, U.S. individuals living and working abroad must apply complicated rules relating to foreign currency transactions. Simplifying certain rules relating to these transactions for U.S. individuals living and working abroad or with other foreign ties would improve compliance and better reflect the economic environment in which these individuals live and work.

For example, a U.S. citizen working abroad who receives 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 the citizen's U.S. tax return.

Another example involves a mortgage on a personal residence. An individual that purchased a residence abroad with a mortgage on the property may have gain attributable to currency fluctuations when the individual sells the residence that are offset economically by currency losses on the individual's mortgage. 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 losses on a mortgage of a personal residence are generally non-deductible personal losses. This could lead to individuals recognizing taxable gain in situations in which no economic gain was realized.

Proposal

The proposal would allow individuals living and working abroad to use an average rate for the year to calculate qualified compensation received in foreign currency, as well as for other items of income or expense of such individuals (including retired individuals) as specified in regulations.

The proposal would increase the personal exemption amount for foreign currency gain from \$200 to \$500, to reflect inflation since 1986, and would index this threshold to inflation on an annual basis.

The proposal would also allow individuals to deduct foreign currency losses realized with respect to mortgage debt secured by a personal residence to the extent of any gain taken into income on the sale of the residence as a result 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, this proposal would not be limited to individuals who live and work abroad.

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

INCREASE THRESHOLD FOR SIMPLIFIED FOREIGN TAX CREDIT RULES AND REPORTING

Current Law

U.S. individuals who pay foreign income taxes on their investment income, such as foreign withholding tax on dividends from foreign equities, generally are allowed a credit against their U.S. tax liability for the foreign income taxes, subject to complex limitation rules. Section 904(j) of the Internal Revenue Code provides an elective exception from these limitation rules for certain individuals who pay or accrue a limited amount of creditable foreign income taxes on their investment income. This exception is available for individuals whose only foreign income for the year is passive income (which includes most interest and dividends) and for whom all such income is reported on a qualified payee Statement. Such Statements include Form 1099-DIV, Dividends and Distributions, Form 1099-INT, Interest Income, Schedule K-1 of Form 1041, Beneficiary's Share of Income, Deductions, Credits, etc., Schedule K-3 of Form 1065, Partner's Share of Income, Deductions, Credits, etc. – International, Schedule K-3 of Form 1120-S, Shareholder's Share of Income, Deductions, Credits, etc. – International, or similar substitute Statements. The exception is further limited to individuals who incur \$300 (\$600 if married and filing a joint return) or less of creditable foreign income taxes for the year.

In addition to being excepted from applying the complex foreign tax credit limitation rules, individuals who elect this exception are also excepted from the requirement to file Form 1116, Foreign Tax Credit (Individual, Estate, or Trust).

Reasons for Change

Increasing the \$300 (\$600 in the case of a joint return) threshold would simplify return preparation for a greater number of individual taxpayers, and approximate inflation since this unindexed threshold was adopted in 1997.

Proposal

The proposal would increase the threshold for the foreign tax credit limitation exception to \$600 (\$1,200 in the case of a joint return) and would index this threshold to inflation.

The proposal would be effective for foreign income taxes paid or accrued in taxable years beginning after December 31, 2022.

MODERNIZE RULES, INCLUDING THOSE FOR DIGITAL ASSETS

MODERNIZE RULES TREATING LOANS OF SECURITIES AS TAX-FREE TO INCLUDE OTHER ASSET CLASSES AND ADDRESS INCOME INCLUSION

Current Law

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. Persons wishing to take a trading position in the security (for example, to short the security as a hedge of another position or in order to benefit from an anticipated fall in price) will borrow the security in order to effect their transaction.

Loans of securities of this kind ordinarily are treated as transactions in which no gain or loss is recognized (nonrecognition treatment) if the transfer of a security is pursuant to an agreement that meets certain requirements. Gain or loss also is not recognized on the return of that security in exchange for rights under the agreement. The agreement must (a) provide for the return to the transferor of securities identical to the securities transferred; (b) require that payments be made to the transferor of amounts equal to all interest, dividends and distributions on the security during the term of the securities loan; (c) not reduce the risk of loss or opportunity for gain of the transferor in the transferred securities; and (d) meet such other requirements as the Secretary or her delegates (Secretary) may prescribe. These rules are intended to ensure that the taxpayer making the loan of securities remains in an economic and tax position similar to the position it would have been in absent the loan. For this purpose, the term “securities” means corporate stock, notes, bonds, debentures and other evidences of indebtedness, and any evidence of an interest in or right to purchase any of the foregoing. The basis of property acquired by a taxpayer in a securities loan when the securities are returned to the taxpayer is the same as the basis of the property loaned by the taxpayer.

Several court cases have ruled that these securities loan nonrecognition rules do not apply to a number of tax-motivated transactions denominated as securities loans with non-market-standard terms, and that the transactions gave rise to taxable gain or loss on the transfer of the security.²⁹ While it is common in the securities lending market for a loan of securities to have a fixed term, in these cases, the security was loaned for a fixed or quasi-fixed term of unusually long duration, among other non-market-standard terms. In one case, the loaned security was a debt instrument that did not have coupons but was issued with significant original issue discount. The taxpayer

²⁹ See *Samueli v. Commissioner*, 619 F.3d 399 (9th Cir. 2011) (tax-motivated transaction in which a taxpayer ostensibly loaned a debt instrument for most of its remaining term and did not qualify for non-recognition treatment under section 1058 of the Internal Revenue Code); *Sollberger v. Commissioner*, 691 F.3d 1119 (9th Cir. 2011) (tax-motivated transaction in which a taxpayer did not receive amounts in respect of distributions where security was nominally loaned for 7 years and did not qualify for non-recognition treatment under section 1058); *Lizzie Calloway*, 135 T.C. 26 (2010) (tax-avoidance transaction in which securities were nominally loaned for three years and did not meet the requirements of section 1058), *aff'd on other grounds*, 691 F.3d 1215 (11th Cir. 2012).

did not take any amounts in respect of the accruing original issue discount into account during the term of the securities loan.³⁰

Reasons for Change

The market for lending of financial and other assets has expanded over time to include digital assets and interests in publicly traded partnerships. The securities loan nonrecognition rules should be amended to take this expansion into account.

Since these rules are intended to ensure that the taxpayer making the loan of securities remains in an economic and tax position similar to the position it would have been in absent the loan, the rules should be further amended to ensure that taxpayers take income from a loan of an asset into account in a manner comparable to the income the taxpayer would have had if it had continued to hold the asset. First, taxpayers should be required to take income accruing on the asset into account as they would do absent the loan. Second, taxpayers should not be able to use securities loans to accelerate gains simply because the term of the loan is fixed.

Expansion of asset classes

In recent years, a market for the lending of digital assets recorded on cryptographically secured distributed ledgers has developed, and it is now growing rapidly. Similar to the securities lending market, owners of these digital assets may lend them in order to receive compensation for doing so. The yields (in digital asset terms) for such loans may be substantially higher than the interest received on loans of cash. Other taxpayers borrow these digital assets in order to carry out various trading strategies or to take speculative positions in those assets or to use those assets as collateral for other transactions. The borrower of the digital asset therefore often will dispose of it in order to carry out its trade, at which point neither the lender nor the borrower holds the digital asset.

Except in the case of digital assets that may also be treated as securities within the meaning of the definition described above, the securities loan nonrecognition rules do not apply to loans of digital assets. No other authority expressly addresses whether loans of assets other than securities give rise to taxable gain or loss. In light of the growing volume of loans of digital assets, rules addressing those transactions should be provided. Those rules should take into account differences between digital assets and securities. One example of those differences is that digital assets typically do not pay dividends or interest, but ownership of digital assets may result in other types of transfers of property to the owner such as hard forks³¹ and airdrops.³²

Another type of financial asset that taxpayers may lend, including pursuant to the terms of brokerage agreements, are equity interests in publicly traded partnerships. Although these equity

³⁰ See *Samueli v. Commissioner*, 619 F.3d 399 (9th Cir. 2011).

³¹ A hard fork is a significant change to the protocol of a blockchain network that effectively results in two different digital assets with a common history. Holders of the digital asset in the original blockchain have access to both the original digital asset and the digital asset on the new blockchain after the hard fork.

³² An airdrop means the transfer of a typically free digital asset to a taxpayer's wallet, generally with no or minimal involvement by the transferee, for example in order to promote or market a new digital asset.

interests function like securities for non-tax purposes, they are not securities for purposes of the securities loan nonrecognition rules. No rules address how such loans are treated, or how the partnership income that would be taken into account by the partner absent the loan is treated. The Secretary should have authority to treat such loans as tax-free if the resulting treatment of partnership income is appropriate.

Inclusion of income from loans of assets

The securities loan nonrecognition rules do not address how the lender of a security that accrues interest or other income during the term of the loan should take that interest or other income into account. If the lender of the security is an accrual method taxpayer but that lender does not take income on the securities loan into account in respect of the interest or other income accruing on the underlying security, income to the lender would be deferred compared to the timing of income if the lender had not loaned the security. Lenders of assets should be required to include income during the term of the loan in a manner comparable to the income inclusions they would have absent the loan.

Some taxpayers treat fixed-term securities loans as within the scope of the securities loan nonrecognition rules. Based on the cases described above, other taxpayers are engaging in short-term fixed-term securities loans for the purpose of generating gains that are used to refresh expiring net operating losses or to give rise to future ordinary deductions. The borrowers in these transactions may have no business reason to borrow these securities other than to accommodate the lender. While a fixed term may indicate that a loan of an asset is a tax-motivated transaction, a fixed term of a duration customary in the market does not by itself substantially change a taxpayer's economic position. Taxpayers should not be able to use such transactions to accelerate gains.

Proposal

The proposal would amend the securities loan nonrecognition rules to provide that they apply to loans of actively traded digital assets recorded on cryptographically secured distributed ledgers, provided that the loan has 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, except as provided by the Secretary. The Secretary would have authority to determine when a digital asset is actively traded, and the authority to extend the rules to non-actively traded digital assets. The proposal also would provide authority to the Secretary to extend the securities loan nonrecognition rules to other assets such as interests in publicly traded partnerships.

The proposal would require that income that would be taken into account 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, except as provided by the Secretary. For example, fixed-term loans entered into in the normal course of a securities lending business or the ordinary management of an investment portfolio ordinarily should be treated as nonrecognition transactions, while a loan of a security for all or virtually all of its remaining term or an accommodation loan entered into to generate tax benefits should not be treated as a qualifying loan.

No inference would be intended regarding the treatment of loans of digital assets or equity interests in publicly traded partnerships under current law, or the treatment of income on loaned securities or fixed-term securities loans under current law.

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

PROVIDE FOR INFORMATION REPORTING BY CERTAIN FINANCIAL INSTITUTIONS AND DIGITAL ASSET BROKERS FOR PURPOSES OF EXCHANGE OF INFORMATION

Current Law

The Foreign Account Tax Compliance Act (FATCA) provisions of the Internal Revenue Code generally require foreign financial institutions to report to the IRS comprehensive information about U.S. accounts. Foreign financial institutions that do not comply with these obligations may be subject to U.S. withholding tax on certain U.S. source payments. Under FATCA, foreign financial institutions are required to report a variety of information to the IRS, including: the account balance or value; amounts such as dividends, interest, and gross proceeds paid or credited to the account without regard to the source of such payments; and information on any substantial U.S. owners of certain passive foreign entities.

Under current law, U.S. source interest paid to a nonresident alien individual on deposits maintained at U.S. offices of certain financial institutions must be reported to the IRS if the aggregate amount of interest paid during the calendar year is 10 dollars or more. Withholding agents, including financial institutions, also are required to report other payments such as U.S. source dividends, royalties, and annuities paid to any foreign recipient. Financial institutions making such payments to U.S. entities with foreign owners are in many cases not required to report information on the foreign owners (for example, foreign shareholders of a U.S. corporation, foreign partners of a U.S. partnership, or the foreign settlors or beneficiaries of a complex trust).

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. A broker means a dealer, barter exchange, or a person who, for a consideration, regularly acts as a middleman with respect to property or services. Section 80603 of the Infrastructure Investment and Jobs Act of 2021 clarifies that a broker includes any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person. Except as otherwise provided by the Secretary or her delegates (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.

Pursuant to an income tax treaty or other international agreement to which the United States is a party and that authorizes the exchange of tax information with a foreign jurisdiction (information exchange agreements), the United States may receive, as well as provide, tax information. Information that is foreseeably relevant for tax administration may be exchanged under these agreements, including information about the identity of beneficial owners of entities.

Reasons for Change

The United States has established a broad network of information exchange relationships with other jurisdictions based on established international standards. The information obtained through those information exchange relationships has been central to recent successful IRS enforcement efforts against offshore tax evasion. The strength of those information exchange relationships depends, however, on cooperation and reciprocity. Further, as the IRS has gained more experience with exchange of tax information on an automatic basis with appropriate partner jurisdictions, it has become clear that a jurisdiction's willingness to share information on an automatic basis with the United States often depends on the United States' willingness and ability to reciprocate by exchanging comparable information.

The ability to exchange information reciprocally is particularly important in connection with the implementation of FATCA. In many cases, foreign law would prevent foreign financial institutions from complying with the FATCA reporting provisions. Such legal impediments are addressed through intergovernmental agreements under which the foreign government (instead of the financial institutions) agrees to provide the information required by FATCA to the IRS. Under many of these agreements, the United States provides some information on residents of the foreign country that hold accounts at a U.S. financial institution. However, the United States provides less information on foreign accounts at a U.S. financial institution than it receives on U.S. accounts at a foreign financial institution.

The intergovernmental agreements include political commitments by the U.S. government to advocate and support relevant legislation to achieve equivalent levels of reciprocal information exchange. In order to fulfill this commitment, legislation is needed to require U.S. financial institutions to report to the IRS certain additional information on foreign account holders. Requiring financial institutions in the United States to report to the IRS the comprehensive information required under FATCA would enable the IRS to provide equivalent levels of information to cooperative foreign governments in appropriate circumstances to support their efforts to address tax evasion by their residents.

In addition, tax evasion using digital assets is a rapidly growing problem. Since the industry is entirely digital, taxpayers can transact with offshore digital asset exchanges and wallet providers without leaving the United States. The global nature of the digital asset market offers opportunities for U.S. taxpayers to conceal assets and taxable income by using offshore digital asset exchanges and wallet providers. U.S. taxpayers also attempt to avoid U.S. tax reporting by creating entities through which they can act. To combat the potential for digital assets to be used for tax evasion, third party information reporting is critical to help identify taxpayers and bolster voluntary tax compliance. In order to ensure that the United States is able to benefit from a global automatic exchange of information framework with respect to offshore digital assets and receive information about U.S. beneficial owners it is essential that United States reciprocally provide information on foreign beneficial owners of certain entities transacting in digital assets with U.S. brokers.

Proposal

The proposal would require certain financial institutions to report the account balance (including, in the case of a cash value insurance contract or annuity contract, the cash value or surrender value) for all financial accounts maintained at a U.S. office and held by foreign persons. The proposal also would expand the current reporting required with respect to U.S. source income paid to accounts held by foreign persons to include similar non-U.S. source payments. In addition, the proposal would 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. Further, the proposal would require financial institutions to report information regarding certain passive entities and their substantial foreign owners. For example, a financial institution maintaining an account for a passive entity that is a trust would be required to obtain and report to the IRS information on the owner(s) of the trust.

When reporting with respect to digital assets held by passive entities, the proposal would require brokers, such as U.S. digital asset exchanges, to report information relating to the substantial foreign owners of the passive entities. The proposal, if adopted, and combined with existing law, would 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. This would allow the United States to share such information on an automatic basis with appropriate partner jurisdictions, in order to reciprocally receive information on U.S. taxpayers that directly or through passive entities engage in digital asset transactions outside the United States pursuant to an international automatic exchange of information framework.

The Secretary would be granted authority to prescribe such regulations or other guidance as may be necessary or appropriate to carry out the purposes of, and prevent the avoidance of, the proposal, including regulations requiring other information that the Secretary determines is necessary to carry out the purposes of the proposal.

The proposal would be effective for returns required to be filed after December 31, 2023.

REQUIRE REPORTING BY CERTAIN TAXPAYERS OF FOREIGN DIGITAL ASSET ACCOUNTS

Current Law

Section 6038D of the Internal Revenue Code (Code) 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 taxable year to attach a Statement with required information (currently provided on IRS Form 8938, Statement of Specified Foreign Financial Asset) to the individual's tax return by the due date (including extensions) for that return. Treasury regulations under section 6038D also apply the requirements of this section to domestic entities formed or availed of for purposes of holding specified foreign financial assets.

A specified foreign financial asset means (a) a financial account maintained by a foreign financial institution, as those terms are defined by section 1471 of the Code, 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.

Failure to provide the required information for a taxable year is subject to a penalty of between \$10,000 and \$60,000 for each such failure, absent reasonable cause. In addition, the accuracy-related penalty on underpayment of tax in section 6662 of the Code, which is typically 20 percent of the underpayment, is increased to 40 percent for an underpayment that is attributable to a transaction involving undisclosed foreign financial assets (defined as any asset with respect to which information was required to be provided under section 6038D, among other sections, but was not provided). In the case of any information which is required to be reported pursuant to section 6038D, the time for assessment of any tax with respect to any tax return, event, or period to which such information relates is extended to three years after the date on which the taxpayer provides the information required to be reported (absent reasonable cause). The statute of limitations in section 6501 for IRS assessment is extended from the usual three years to six years if a taxpayer fails to report an amount of income (above a de minimis threshold of \$5,000) that is attributable to an asset subject to reporting under section 6038D (or would be required to be reported if section 6038D were applied without regard to the \$50,000 threshold, and without regard to any exceptions identified by the Secretary or her delegates (Secretary) in regulations).

Reasons for Change

Tax compliance and enforcement with respect to digital assets is a rapidly growing problem. Since the industry is entirely digital, taxpayers can transact with offshore digital asset exchanges and wallet providers without leaving the United States. The global nature of the digital asset market offers opportunities for U.S. taxpayers to conceal assets and taxable income by using offshore digital asset exchanges and wallet providers. U.S. taxpayers also attempt to avoid U.S. tax reporting by creating entities through which they can act. Requiring individuals specifically

to report their offshore holdings of accounts with digital assets, subject to significant penalties if they fail to do so, is critical to combat the potential for digital assets to be used for tax avoidance.

Proposal

The proposal would amend section 6038D(b) of the Code to require reporting with respect to a new third category of asset (i.e., in addition to (a) a financial account maintained by a financial institution, and (b) certain specified assets not held in a financial account maintained by such a financial institution). The new third category would be 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 be required only for taxpayers that hold an aggregate value of all three categories of assets in excess of \$50,000 (or such higher dollar amount as the Secretary may prescribe). Conforming technical amendments to the Code would be made, as well.

Except as otherwise provided by the Secretary, a foreign digital asset account would be defined based on where the exchange or service provider is organized or established. The Secretary may prescribe regulations to expand the scope of foreign digital asset accounts for purposes of this section. The Secretary would also have authority to prescribe regulations to coordinate this amendment with other rules to mitigate duplication or minimize burden with respect to other types of reporting rules.

The proposal would be effective for returns required to be filed after December 31, 2022.

AMEND THE MARK-TO-MARKET RULES FOR DEALERS AND TRADERS TO INCLUDE DIGITAL ASSETS

Current Law

Section 475 of the Internal Revenue Code 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 which 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.

Gain or loss on dealer securities is generally treated as ordinary income or loss, unless the security is (a) a security held for investment or not held for sale or a hedge of a non-security, if properly identified as such, or (b) is held other than in connection with securities dealer activities. Gain or loss on other assets that are marked to market pursuant to an election also generally is treated as ordinary income or loss. Limitations on the deductibility of capital losses therefore generally do not apply to losses on assets marked to market under these rules. Several anti-abuse rules addressed to timing and character arbitrage do not apply to securities that are marked to market under these rules.

Reasons for Change

Mark-to-market accounting generally provides a clear reflection of income with respect to assets that are traded in established markets. For market-valued assets, mark-to-market accounting imposes few burdens and offers few opportunities for manipulation. Exchange-traded assets typically have reliably determinable values if they are actively traded. For financial accounting purposes, taxpayers may be required to mark inventory or trading positions to market, including at year-end. To the extent that financial accounting valuation is consistent with the determination of fair market value for tax purposes, allowing taxpayers to use their financial accounting valuations for tax purposes may reduce tax compliance costs.

Thousands of different digital assets are currently in existence. While many of them are illiquid, some of them are traded in high volumes and may have reliable valuations.

Allowing taxpayers to mark actively traded digital assets to market would clearly reflect income and could reduce tax compliance burdens, just as current law does for other assets of commodities dealers and securities traders. Notably, for financial accounting purposes, taxpayers may be required to mark inventory or trading positions to market, including at year-end.

Proposal

The proposal would add a third category of assets that may be marked-to-market at the election of a dealer or trader in those assets. Assets in the third category would be actively traded digital

assets and derivatives on, or hedges of, those digital assets, under rules similar to those that apply to actively traded commodities. The Secretary and her delegates would have authority to determine which digital assets are treated as actively traded. The determination of whether a digital asset is actively traded would take into account 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 the new third category of assets.

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

IMPROVE BENEFITS TAX ADMINISTRATION

CLARIFY TAX TREATMENT OF FIXED INDEMNITY HEALTH POLICIES

Current Law

A fixed indemnity health policy pays covered individuals a specified amount of cash for the occurrence of certain health-related events, such as a medical office visit or days in the hospital. Similarly, a critical disease or specified disease policy pays a specified amount upon the diagnosis of a specific disease. Under these types of policies, the amount paid is neither based upon the amount of any medical expense incurred related to the event or illness that triggered payment nor coordinated with other health coverage. Under certain circumstances, the payment may be excluded from the employee's gross income and wages to the extent that the payment does not exceed the employee's actual medical care expenses.

The Internal Revenue Code (Code) generally defines gross income to include compensation for services, including fees, commissions, fringe benefits, and similar items, but any amount paid to fund employer-provided coverage under an accident or health plan generally is excluded from an employee's gross income. Furthermore, an employee generally may exclude from gross income amounts received through an employer-provided accident or health plan if these amounts reimburse expenses incurred by the employee for medical care. Amounts that exceed the employee's medical expenses are included in the employee's gross income under longstanding IRS guidance.

An individual who purchases accident or health insurance with after-tax dollars generally does not include in gross income the amounts paid through the policy for personal injuries or sickness. This exclusion from gross income does not apply, however, if the amounts are either (a) attributable to employer contributions that were not includable in the employee's gross income, (b) pre-tax salary reduction contributions employee make through a section 125 plan, or (c) paid directly by the employer. For example, if an individual purchases an accident or health policy with after-tax funds, the individual may exclude the full amount of any payment under the policy from income, even if that amount exceeds individual's medical expenses that triggered the payment.

Finally, amounts paid to reimburse an employee's medical care expenses for personal injuries or sickness are also not treated as compensation (or wages) subject to tax under the Federal Insurance Contribution Act (FICA) or the Federal Unemployment Tax Act (FUTA). Thus, amounts paid under employer-provided coverage for medical care are excluded from FICA and FUTA taxes, in addition to being excluded from gross income for Federal income tax purposes.

Reasons for Change

Employers increasingly offer employees insured fixed indemnity benefits, which provide the employees with a fixed payment upon a specified medical event, instead of or in addition to traditional medical expense-based coverage. Employers typically claim a deduction from income

taxes for the full cost of the fixed indemnity coverage and do not include the cost of these benefits when calculating income tax withholding and FICA and FUTA taxes on employees' compensation income. Insurers, employers, and employees generally fail to track the amount of the employees' medical expenses tied to the medical event that triggered the fixed payment, despite the importance of these amounts for determining the amount that is properly excludable from employees' gross income. As a result, employers who fail to track expenses generally fail to include the amount of any fixed payment in excess of actual medical expenses in the employees' gross income for income tax purposes or in compensation (or wages) for FICA and FUTA tax purposes. This leads to an underpayment of taxes owed.

Proposal

The proposal would amend section 105(b) of the Code to clarify that the exclusion from gross income for payments received through an employer-provided accident or health plan applies only to the amount paid directly or indirectly for a specific medical expense. Any fixed payment (in the form of a direct payment, reimbursement, loan, or advance reimbursement) to an employee under a fixed indemnity arrangement that is paid without regard to the actual cost of the medical expenses the employee incurred would not be excluded from gross income and would be treated as wages subject to FICA and FUTA taxes. Under the proposal, fixed indemnity arrangements would be defined to include certain critical disease or specified disease policies and arrangements that provide fixed payments for specific items and services according to detailed payment schedules, thus making payments from these policies subject to Federal income, FICA, and FUTA taxes. Individuals would still be able to exclude from gross income any fixed amounts paid through an accident or health policy purchased with after-tax dollars.

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

CLARIFY TAX TREATMENT OF ON-DEMAND PAY ARRANGEMENTS

Current Law

For purposes of employment taxes (social security and Medicare taxes, unemployment tax, and income tax withholding), wages are defined in the Internal Revenue Code (Code) as all remuneration for services performed by an employee for their employer, including the cash value of all remuneration paid in any medium other than cash. Employers withhold and pay employment taxes based on payroll periods. A payroll period is defined for employment tax purposes as a period for which a payment of wages is ordinarily made to the employee by the employer, and a miscellaneous payroll period is defined as a payroll period other than a daily, weekly, biweekly, semimonthly, monthly, quarterly, semiannual, or annual payroll period.

Longstanding employment tax regulations provide that wages are considered paid when they are actually or constructively received by the employee. An employee is in constructive receipt of wages when an amount is set apart or otherwise made available so that the employee may draw upon that amount at any time. Furthermore, when an employee has unfettered control over the date on which they actually receive their wages, they are typically considered to be in constructive receipt of those wages.

Reasons for Change

Employers and third-party payors increasingly allow employees to receive payment of earned wages before their regularly scheduled pay dates (these arrangements are referred to here as “on-demand pay” arrangements; however, the arrangements are referred to in various ways by employers and third-party payors, including as “earned wage access programs”). On-demand pay arrangements vary significantly, but generally, employees use mobile applications to access accrued wages before the end of their regular pay cycle and the amounts are transferred (almost instantaneously) to a bank account, pre-paid debit card, or payroll card.

Employees with access to an on-demand pay arrangement may be in constant constructive receipt of their wages as they are earned. Employers that offer on-demand pay arrangements should maintain either a daily or a miscellaneous payroll period and should withhold and pay employment taxes on employees’ earned wages on a daily basis.

It is unlikely that many, if any, employers or third-party payors treat employees with access to on-demand pay arrangements as being in constructive receipt of their wages because it would be a significant financial and administrative burden on the employers or third-party payors to configure their payroll systems and make payroll deposits on a daily basis. To avoid treating employees as being in constant constructive receipt of their wages, some employers or third-party payors ignore the constructive receipt issue entirely or treat the arrangement as a loan from the employer to the employee. The result in either case is that wages are treated as paid on the regularly scheduled pay dates, rather than when the wages are constructively received by the employees.

Legislation addressing the tax treatment of on-demand pay would provide certainty and uniformity for taxpayers and would establish a uniform and administrable system for the IRS. Without legislation, on-demand pay arrangements will continue to proliferate with some taxpayers taking aggressive tax positions on the timing of the wage payment for employment tax purposes and the timing of the withholding and deposit of the employment taxes.

Proposal

The proposal would amend section 7701 of the Code to 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 also would amend section 3401(b) of the Code to 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 amend sections 3102, 3111, and 3301 of the Code to clarify that on-demand pay arrangements are not loans. Finally, section 6302 of the Code would be amended to provide special payroll deposit rules for on-demand pay arrangements. The Secretary and her delegates would be provided regulatory authority to implement the Code provisions addressing on-demand pay arrangements.

The proposal would be effective for calendar years and quarters beginning after December 31, 2022.

RATIONALIZE FUNDING FOR POST-RETIREMENT MEDICAL AND LIFE INSURANCE BENEFITS

Current Law

An employer can make deductible contributions to a welfare benefit fund, provided that the amount set aside does not exceed the account limit. In general, the account limit for a year is the amount needed to fund specified welfare benefits for the current year (including administrative expenses).³³ An exception to this limit allows an employer to accumulate an “additional reserve” for post-retirement medical and life insurance benefits. Under section 419A of the Internal Revenue Code (Code), this reserve must be “funded over the working lives of the covered employees and actuarially determined on a level basis.”

In *Wells Fargo & Co v. Commissioner of Internal Revenue Service*,³⁴ the U.S. Tax Court held that an employer establishing a reserve for post-retirement medical and life insurance benefits may make a lump sum contribution to fund the entire liability for these benefits for current retirees.

Reasons for Change

The current system for funding the reserve for post-retirement benefits is vulnerable to abuse. Under current law, there is no mechanism to ensure that an employer that contributes to the reserve honor the implied promise to provide medical and life insurance benefits to retirees. In addition, if the employer eliminates or cuts back on the promise, there is no specific prohibition against using the funds that are no longer needed to provide post-retirement benefits to instead provide other welfare benefits. Therefore, an employer can effectively accelerate deductions for welfare benefits provided to current employees by making a lump sum contribution to a reserve for retirees’ future benefits in one year, eliminating or reducing those retiree benefits, and then in subsequent years directing those funds towards the cost of providing welfare benefits for current employees.

Proposal

The proposal 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 taxable years beginning after December 31, 2022.

³³ The specified welfare benefits are (a) disability benefits, (b) medical benefits, (c) supplemental unemployment benefits or severance pay benefits, and (d) life insurance benefits.

³⁴ 120 T.C. No. 5, 120 T.C. 69, 2003 WL 301884 (U.S. Tax Ct. 2003).

TABLE OF REVENUE ESTIMATES

REVENUE ESTIMATES OF THE ADMINISTRATION'S FISCAL YEAR 2023 REVENUE PROPOSALS 1/ 2/

(fiscal years, in millions of dollars)

	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2023-27	2023-32
REFORM BUSINESS AND INTERNATIONAL TAXATION:													
Raise the corporate income tax rate to 28 percent	0	83,500	138,893	136,355	134,942	137,761	139,987	137,573	135,244	134,857	135,448	631,451	1,314,560
Adopt the Undertaxed Profits Rule	0	0	20,427	33,464	29,329	26,655	26,170	25,638	25,109	25,665	27,006	109,875	239,463
Provide tax incentives for locating jobs and business activity in the United States and remove tax deductions for shipping jobs overseas:													
<i>Provide tax credit for inshoring jobs to the United States</i>	0	-8	-13	-14	-14	-15	-16	-16	-17	-18	-18	-64	-149
<i>Remove tax deductions for shipping jobs overseas</i>	0	8	13	14	14	15	16	16	17	18	18	64	149
Subtotal, Provide tax incentives for locating jobs and business activity in the United States and remove tax deductions for shipping jobs overseas	0	0	0	0	0	0	0	0	0	0	0	0	0
Prevent basis shifting by related parties through partnerships	0	3,320	5,676	5,912	6,153	6,401	6,621	6,785	6,887	6,959	7,025	27,462	61,739
Conform definition of "control" with corporate affiliation test	0	761	1,104	1,125	1,143	1,158	1,170	1,179	1,182	1,182	1,176	5,291	11,180
Expand access to retroactive qualified electing fund elections	0	0	1	2	2	3	4	5	6	7	9	8	39
Expand the definition of foreign business entity to include taxable units	0	300	324	290	193	89	96	103	112	120	130	1,196	1,757
Subtotal, Reform Business and International Taxation	0	87,881	166,425	177,148	171,762	172,067	174,048	171,283	168,540	168,790	170,794	775,283	1,628,738
SUPPORT HOUSING AND URBAN DEVELOPMENT:													
Make permanent the New Markets Tax Credit	0	0	0	0	-97	-278	-483	-716	-990	-1,290	-1,602	-375	-5,456
Allow selective basis boosts for bond-financed Low-Income Housing Credit projects	0	-2	-29	-140	-354	-617	-895	-1,148	-1,359	-1,561	-1,769	-1,142	-7,874
Subtotal, Support Housing and Urban Development	0	-2	-29	-140	-451	-895	-1,378	-1,864	-2,349	-2,851	-3,371	-1,517	-13,330
MODIFY FOSSIL FUEL TAXATION:													
Eliminate fossil fuel tax preferences:													
<i>Repeal the enhanced oil recovery credit</i>	0	0	0	31	80	130	186	237	271	301	330	241	1,566
<i>Repeal the credit for oil and natural gas produced from marginal wells</i>	0	0	3	52	144	219	265	288	301	317	333	418	1,922
<i>Repeal the expensing of intangible drilling costs</i>	0	1,508	2,231	1,806	1,401	847	600	597	601	590	561	7,793	10,742
<i>Repeal the deduction for costs paid or incurred for any qualified tertiary injectant used as part of a tertiary recovery method</i>													
<i>Repeal the exception to passive loss limitations provided to working interests in oil and natural gas properties</i>	0	10	9	9	9	8	8	8	8	7	7	45	83

included in repeal the enhanced oil recovery credit

REVENUE ESTIMATES OF THE ADMINISTRATION'S FISCAL YEAR 2023 REVENUE PROPOSALS 1/ 2/

(fiscal years, in millions of dollars)

	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2023-27	2023-32
<i>Repeal the use of percentage depletion with respect to oil and natural gas wells</i>	0	925	1,037	1,085	1,178	1,267	1,351	1,433	1,510	1,579	1,649	5,492	13,014
<i>Increase geological and geophysical amortization period for independent producers</i>	0	631	831	930	1,008	1,045	1,086	1,128	1,158	1,193	1,218	4,445	10,228
<i>Repeal expensing of mine exploration and development costs</i>	0	131	194	156	122	74	52	52	52	50	49	677	932
<i>Repeal percentage depletion for hard mineral fossil fuels</i>	0	163	183	191	208	224	239	253	267	279	291	969	2,298
<i>Repeal capital gains treatment for royalties</i>	0	27	52	54	57	62	64	66	69	71	73	252	595
<i>Repeal the exemption from the corporate income tax for fossil fuel publicly traded partnerships</i>	0	0	0	0	0	0	90	176	216	253	288	0	1,023
<i>Repeal the Oil Spill Liability Trust Fund excise tax exemption for crude oil derived from bitumen and kerogen-rich rock</i>	0	29	38	39	40	41	41	42	43	45	46	187	404
<i>Repeal accelerated amortization for air pollution control facilities</i>	0	14	34	54	71	88	103	117	115	103	92	261	791
<i>Subtotal, Eliminate fossil fuel tax preferences</i>	0	3,438	4,612	4,407	4,318	4,005	4,085	4,397	4,611	4,788	4,937	20,780	43,598
<i>Modify Oil Spill Liability Trust Fund (OSLTF) financing and Superfund excise taxes:</i>													
<i>Eliminate tax exemption for crude oil derived from bitumen and kerogen-rich rock for the Superfund</i>	0	64	85	87	88	88	89	90	92	95	95	412	873
<i>Eliminate drawback for the OSLTF</i>	0	53	70	71	72	72	72	72	72	72	72	338	698
<i>Subtotal, Modify OSLTF financing and Superfund excise taxes</i>	0	117	155	158	160	160	161	162	164	167	167	750	1,571
Subtotal, Modify Fossil Fuel Taxation	0	3,555	4,767	4,565	4,478	4,165	4,246	4,559	4,775	4,955	5,104	21,530	45,169
STRENGTHEN TAXATION OF HIGH-INCOME TAXPAYERS:													
<i>Increase the top marginal income tax rate for high earners</i>	5,861	23,895	39,877	46,351	19,648	7,909	8,573	9,153	9,796	10,451	11,156	137,680	186,809
<i>Reform the taxation of capital income</i>	263	5,464	15,229	17,487	17,979	17,969	18,452	19,224	20,025	20,885	21,774	74,128	174,488
<i>Impose a minimum income tax on the wealthiest taxpayers</i>	0	0	36,115	40,478	42,662	43,395	43,053	42,591	38,087	36,047	38,415	162,650	360,843
Subtotal, Strengthen Taxation of High-income Taxpayers	6,124	29,359	91,221	104,316	80,289	69,273	70,078	70,968	67,908	67,383	71,345	374,458	722,140
SUPPORT FAMILIES AND STUDENTS:													
<i>Make adoption tax credit refundable and allow certain guardianship arrangements to qualify 3/</i>	0	-11	-2,037	-1,244	-1,015	-1,038	-1,009	-1,016	-1,031	-1,043	-1,050	-5,345	-10,494
<i>Provide income exclusion for student debt relief 3/</i>	0	0	0	0	-2	-17	-41	-266	-292	-320	-351	-19	-1,289
Subtotal, Support Families and Students	0	-11	-2,037	-1,244	-1,017	-1,055	-1,050	-1,282	-1,323	-1,363	-1,401	-5,364	-11,783

REVENUE ESTIMATES OF THE ADMINISTRATION'S FISCAL YEAR 2023 REVENUE PROPOSALS 1/ 2/
(fiscal years, in millions of dollars)

	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2023-27	2023-32
MODIFY ESTATE AND GIFT TAXATION:													
Modify income, estate and gift tax rules for certain grantor trusts	0	452	1,699	2,405	2,349	3,950	4,949	5,504	6,049	6,912	7,261	10,855	41,530
Require consistent valuation of promissory notes	0	342	716	747	697	695	658	649	637	619	601	3,197	6,361
Improve tax administration for trusts and decedents' estates	0	-15	-23	-24	-25	-30	-34	-38	-43	-45	-49	-117	-326
Limit duration of generation-skipping transfer tax exemption													
Subtotal, Modify Estate and Gift Taxation	0	779	2,392	3,128	3,021	4,615	5,573	6,115	6,643	7,486	7,813	13,935	47,565
CLOSE LOOPHOLES:													
Tax carried (profits) interests as ordinary income	0	406	677	675	674	672	679	692	706	720	735	3,104	6,636
Repeat deferral of gain from like-kind exchanges	0	676	1,857	1,914	1,971	2,030	2,091	2,154	2,218	2,285	2,354	8,448	19,550
Require 100 percent recapture of depreciation deductions as ordinary income for certain depreciable real property	0	35	113	233	364	505	657	821	1,000	1,192	1,400	1,250	6,320
Limit a partner's deduction in certain syndicated conservation easement transactions	0	925	4,689	2,739	2,114	1,488	1,261	1,299	1,337	1,377	1,419	11,955	18,648
Limit use of donor advised funds to avoid private foundation payout requirement	0	16	15	10	6	3	2	3	3	3	3	50	64
Extend the period for assessment of tax for certain Qualified Opportunity Fund investors	0	4	13	15	15	13	10	9	8	6	2	60	95
Establish an untaxed income account regime for certain small insurance companies	0	908	2,241	1,017	865	795	764	757	748	739	730	5,826	9,564
Expand pro rata interest expense disallowance for business-owned life insurance	0	530	540	582	619	665	704	739	774	812	850	2,936	6,815
Correct drafting errors in the taxation of insurance companies under the Tax Cuts and Jobs Act of 2017	0	86	112	116	100	75	70	63	59	55	51	489	787
Define the term "ultimate purchaser" for purposes of diesel fuel exportation	0	4	6	9	10	13	14	17	20	22	24	42	139
Subtotal, Close Loopholes	0	3,590	10,263	7,310	6,738	6,259	6,252	6,554	6,873	7,211	7,568	34,160	68,618
IMPROVE TAX ADMINISTRATION AND COMPLIANCE:													
Enhance accuracy of tax information:													
<i>Expand the Secretary's authority to require electronic filing for forms and returns</i>													
<i>Improve information reporting for reportable payments subject to backup withholding</i>	0	38	87	148	202	211	221	231	241	252	276	686	1,907
Subtotal, Enhance accuracy of tax information	0	38	87	148	202	211	221	231	241	252	276	686	1,907

negligible revenue effect

REVENUE ESTIMATES OF THE ADMINISTRATION'S FISCAL YEAR 2023 REVENUE PROPOSALS 1/ 2/

(fiscal years, in millions of dollars)

	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2023-27	2023-32
Address taxpayer noncompliance with listed transactions:													
<i>Extend statute of limitations for listed transactions</i>	0	23	51	64	78	76	74	73	72	70	69	292	650
<i>Impose liability on shareholders to collect unpaid income taxes of applicable corporations</i>	0	430	448	466	485	505	525	548	571	596	622	2,334	5,196
Subtotal, Address taxpayer noncompliance with listed transactions	0	453	499	530	563	581	599	621	643	666	691	2,626	5,846
Amend the centralized partnership audit regime to permit the carryover of a reduction in tax that exceeds a partner's tax liability	0	-5	-5	-5	-5	-6	-6	-7	-7	-7	-7	-26	-60
Incorporate Chapters 2/2A in centralized partnership audit regime proceedings													
Authorize limited sharing of business tax return information to measure the economy more accurately													
Impose an affirmative requirement to disclose a position contrary to a regulation	0	5	7	11	11	12	12	14	14	15	15	46	116
Require employers to withhold tax on failed nonqualified deferred compensation plans	0	555	580	605	631	658	687	718	752	787	824	3,029	6,797
Extend to six years the statute of limitations for certain tax assessments													
Expand and increase penalties for noncompliant return preparation and e-filing and authorize IRS oversight of paid preparers:													
<i>Expand and increase penalties for noncompliant return preparation and e-filing 3/</i>	0	14	31	38	45	51	53	55	58	60	63	179	468
<i>Grant authority to IRS for oversight of all paid preparers 3/</i>	0	25	34	45	51	50	54	58	64	70	76	205	527
Subtotal, Expand and increase penalties for noncompliant return preparation and e-filing and authorize IRS oversight of paid preparers	0	39	65	83	96	101	107	113	122	130	139	384	995
Address compliance in connection with tax responsibilities of expatriates	0	0	1	1	1	1	1	2	2	2	2	4	13
Simplify foreign exchange gain or loss rules and exchange rate rules for individuals	0	-1	-2	-2	-2	-3	-3	-3	-3	-3	-3	-10	-25
Increase threshold for simplified foreign tax credit rules and reporting	0	-14	-25	-27	-29	-31	-31	-32	-32	-32	-34	-126	-287
Subtotal, Improve Tax Administration and Compliance	0	1,070	1,207	1,344	1,468	1,524	1,587	1,657	1,732	1,810	1,903	6,613	15,302

MODERNIZE RULES, INCLUDING THOSE FOR DIGITAL ASSETS:

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

negligible revenue effect

REVENUE ESTIMATES OF THE ADMINISTRATION'S FISCAL YEAR 2023 REVENUE PROPOSALS 1/ 2/
(fiscal years, in millions of dollars)

	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2023-27	2023-32
Provide for information reporting by certain financial institutions and digital asset brokers for purposes of exchange of information	0	48	95	179	209	222	237	251	267	287	303	753	2,098
Require reporting by certain taxpayers of foreign digital asset accounts	0	50	100	188	220	234	250	264	282	302	319	792	2,209
Amend the mark-to-market rules for dealers and traders to include digital assets	0	4,846	133	146	161	177	194	214	235	259	284	5,463	6,649
Subtotal, Modernize Rules, Including Those for Digital Assets	0	4,944	328	513	590	633	681	729	784	848	906	7,008	10,956

IMPROVE BENEFITS TAX ADMINISTRATION:

Clarify tax treatment of fixed indemnity health policies
 Clarify tax treatment of on-demand pay arrangements
 Rationalize funding for post-retirement medical and life insurance benefits

Subtotal, Improve Benefits Tax Administration

TOTAL, ADMINISTRATION'S FISCAL YEAR 2023 REVENUE PROPOSALS	6,124	131,165	274,537	296,940	266,878	256,586	260,037	258,719	253,583	254,269	260,661	1,226,106	2,513,375
Total, receipt effect	6,124	131,153	276,512	298,115	267,822	257,557	260,978	259,686	254,565	255,264	261,663	1,231,159	2,523,315
Total, outlay effect	0	-12	1,975	1,175	944	971	941	967	982	995	1,002	5,053	9,940

NOTES

- Presentation in this table does not necessarily reflect the order in which these proposals were estimated.
- The FY 2023 Budget includes additional receipts effects from the proposals to: fund the Federal Payment Levy Program via collections, require coverage of three primary care visits and three behavioral health visits without cost-sharing, improve access to behavioral healthcare in the private insurance market, establish a user fee for the Electronic Visa Update System, and create a mandatory reemployment services and eligibility assessment program.
- This proposal affects both receipts and outlays. Both effects are shown above. The outlay effects included in these estimates are listed below.

Make adoption tax credit refundable and allow certain guardianship arrangements to qualify	0	0	1,995	1,202	973	996	967	974	989	1,001	1,008	5,166	10,105
Provide income exclusion for student debt relief	0	0	0	0	0	1	1	21	24	27	29	1	103
Expand and increase penalties for noncompliant return preparation and e-filing	0	0	-6	-6	-6	-7	-7	-7	-8	-8	-8	-25	-63
Grant authority to IRS for oversight of all paid preparers	0	-12	-14	-21	-23	-19	-20	-21	-23	-25	-27	-89	-205
Total, outlay effect	0	-12	1,975	1,175	944	971	941	967	982	995	1,002	5,053	9,940