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2014 Ways and Means Chairman's Tax Reform Discussion Draft

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Overview

The 979-page tax reform "discussion draft" released February 26 by House Ways and Means Committee Chairman Dave Camp (R-MI) would rewrite the Internal Revenue Code in much the same way Congress did in 1986.

The discussion draft is intended to achieve revenue-neutral tax reform, broadening the tax base by modifying or eliminating tax expenditures—variations from measures of economic income—and using the revenue saved to offset corresponding reductions in the statutory tax rates. These types of changes have the effect of redistributing tax burdens among taxpayers and industries. Understanding the interactive effect of the many simultaneous changes that would be made by the draft is one of the challenges in analyzing the effect of tax reform.

Apart from comprehensive redistributive reform, the draft would make scores of technical changes to the remaining Code provisions. The point of these changes is to simplify the application of the affected provisions and address inconsistencies and technical problems that may prevent those provisions from effecting their intended purposes. These technical changes, in many cases, would potentially be of benefit whether or not comprehensive reform is enacted.

An overview of the discussion draft follows, focusing broadly on provisions affecting business and industry and provisions affecting individuals.

Business and industry provisions

Corporate and partnership taxation

The draft would reduce the statutory maximum corporate tax rate to 25% over five years, eliminating the current 15% tax bracket. It would also eliminate the corporate alternative minimum tax (unused AMT credits would be refundable over several years).

The cost of the reduction in the rate would be offset by base-broadening measures to eliminate or modify substantially dozens of tax preferences for various activities and products, including the following:

- The draft would repeal the modified accelerated cost recovery system for business assets and replace it with one that lengthens recovery lives and indexes the depreciable basis for inflation.
- Research and advertising expenses would be amortized, instead of being expensed as they are currently.
- Net operating loss (NOL) rules would be modified to limit the amount of NOL deductions permissible in any year.
- The last-in, first-out and lower-of-cost-or-market methods of accounting for inventory would be repealed.
- The deduction currently allowed for U.S. manufacturing income would be phased out.

The draft would tax some income from the partnership profits interest of managers of some investment funds as ordinary income—the "carried interest" income that currently may be taxed as capital gains; this provision is quite different from previous carried interest proposals.

Other provisions relevant to passthrough entities include changes to the employment tax rules for partners and S corporation shareholders; changes to some of the technical subchapter K and subchapter S rules; new streamlined partnership audit procedures; changes to the rules regarding which PTPs can be taxed as partnerships; and a number of changes to the REIT rules, including a new rule prohibiting REITs from satisfying the requirements for tax-free spin-offs.

Financial institutions

A new excise tax would be imposed on the assets of "systemically important" financial institutions. Assets of such institutions above $500 billion would be subject to an annual charge of 14 basis points.

Other provisions of interest to financial institutions include a rule that would prevent arbitrage of deductible interest expense and tax-exempt income. Also, certain derivatives transactions would be marked to market annually, and interest paid on private activity bonds would no longer be tax-exempt.

Multinational entity taxation

The draft proposes significant changes to the taxation of business income earned outside the United States. The draft would move from the current system, which permits deferral of the U.S. tax on foreign active business earnings until those earnings are repatriated, to a "territorial" system. Active foreign earnings of U.S. companies would be allowed a dividends received deduction of 95%—thus eliminating most residual U.S. tax. This system is necessarily quite complex, however, as the exemption of virtually all active foreign earnings from U.S. tax requires effective measures to prevent the offshore shifting of profits, which would erode the U.S. tax base.

Income from intangibles deemed to be income in excess of 10% of the basis of assets would be subject to tax, but at a reduced rate effected, after phase-in, by a 40% deduction.

The draft also includes other measures to avoid erosion of the U.S. tax base through, for example, the excessive placement of debt in the United States relative to worldwide group debt.

The transition to the territorial system would address accumulated, untaxed foreign earnings, reportedly in excess of $2 trillion. It would deem those earnings to be repatriated to the United States, but taxed at one of two reduced rates, depending on how the earnings have been deployed. Earnings in cash or cash equivalents would be taxed at 8.75%, while other earnings, perhaps invested in plant and equipment, would be subject to a 3.5% rate. The resulting tax could be paid in installments over eight years.

Technical changes

The draft would make the research credit permanent, but it would simplify it by allowing only the alternative simplified credit method (at a 15% rate) and a credit for basic research and by eliminating some categories of eligible expenses (such as for software development). It would also make extensive changes to the provisions in the areas of insurance, real estate, tax-exempt financing, executive compensation, and partnerships and other passthrough entities. Dozens of special business credits and deductions would be repealed.

Individual provisions

The seven current tax brackets would be reduced to three: 10%, 25%, and 35%. The top rate, reduced from 39.6%, would apply to single filers with income of $400,000 and married joint filers with income of $450,000.

Capital gains and dividends would be taxed at these same ordinary rates, but only after a 40% deduction, correspondingly reducing the effective rate.

The individual AMT, like the corporate AMT, would be repealed. At the same time, the standard deduction would be increased.

The revenue cost of these changes would be offset, also as in the case of the corporate reform changes, by modifying or eliminating a number of tax preferences, many of them significant and of long standing. Personal exemptions would be eliminated. For those who itemize deductions, the principal limitation of the home mortgage interest deduction would be reduced from $1 million to $500,000, and the deduction for state and local taxes would be eliminated. In addition, the benefit of itemized deductions (other than the deduction for charitable contributions) and the standard deduction would be capped at the 25% rate, reducing their value to higher-income taxpayers.

Also capped at the 25% rate would be tax preferences involving exclusions from income, in essence imposing a 10% surtax on these items. Among the capped preferences would be the exclusion for employer-provided health, accident, and defined contribution retirement benefits, along with excluded foreign earned income, tax-exempt interest, and untaxed Social Security benefits. Deductions for health premiums for the self-employed and for contributions to health savings accounts would be subject to the cap.

Technical changes

The technical changes for current provisions of the Code are extensive and are designed to eliminate inconsistencies and overlaps, as well as to more narrowly target incentives.

Among the most significant technical reforms are those that address the great number of tax benefits for higher education. According to the Ways and Means Committee, those tax benefits currently number 15. The discussion draft would consolidate them into five:

- A permanent American Opportunity Tax Credit
- A deduction for work-related education expenses
- An exclusion for scholarships and grants
- A gift tax exclusion for tuition payments
- Tax-free section 529 plans

More than a score of special credits and deductions would be repealed.

Although it currently appears unlikely that comprehensive tax reform legislation will be enacted this year, the discussion draft is expected to be an important starting point in future discussions of tax reform. KPMG's Washington National Tax professionals have produced the following analysis of the separate elements of the discussion draft, summarizing the proposals and providing some initial observations about their potential impact.

Unless otherwise indicated, all Code section references are to the Internal Revenue Code of 1986, as amended. All "Reg. section" references are to the applicable regulations promulgated pursuant to the Code. Other section references are to the numbered sections of the Ways and Means discussion draft released on February 26, 2014.

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Business and industry

Corporate tax provisions

Tax rates

Reduction of maximum corporate tax rate to 25%. A provision of the discussion draft (section 3001 of the draft legislation) would reduce the maximum corporate tax rate from 35% to 25% beginning in 2019 (and make various corresponding changes throughout the Code). A transition rule would phase in the rate reduction between 2015 and 2019.

The proposal also would repeal the maximum corporate tax rate on net capital gain (in section 1201) as obsolete.

KPMG observation

This reduction seeks to make the U.S. corporate tax rate more competitive with those of other countries. Also, it is consistent with the overall theme of the proposal to lower tax rates in exchange for the elimination of certain tax benefits.

Reform business-related exclusions and deductions

Repeal contribution-to-capital rules. A provision of the discussion draft (section 3101 of the draft legislation) would repeal Code section 118 (which currently provides that a corporation does not recognize income on its receipt of a capital contribution) and add new section 76.

New Code section 76 would provide that gross income includes any contribution to the capital of a corporation, other than a contribution of money or property made in exchange for stock of such corporation. Similar rules would apply to entities other than corporations. The Joint Committee on Taxation (JCT) technical explanation of the discussion draft provides the following example:

> For example, a contribution of municipal land by a municipality that is not in exchange for stock (or for a partnership interest or other interest) of equivalent value is considered a contribution to capital that is includable in gross income. By contrast, a municipal tax abatement for locating a business in a particular municipality is not considered a contribution to capital.

The proposal would amend Code section 362(a), which provides rules to determine the basis of certain property acquired by corporations in certain tax-free transactions, by striking the phrase "contribution to capital" in section 362(a)(2) and replacing it with "…a contribution in exchange for stock of such corporation (determined under rules similar to the rules of [section 76])."

The proposal would amend Code section 362(c) to provide that, if property other than money is transferred to a corporation as a contribution to capital within the meaning of section 76, the basis of such property in the hands of the corporation will be the greater of: (1) the basis in the hands of the transferor, increased by the amount of gain recognized to the transferor on the transfer; or (2) the amount included in gross income by such corporation under section 76.

The proposal also would repeal section 108(e)(6). Currently, section 108(e)(6) provides that, for purposes of determining cancellation of indebtedness income, if a debtor corporation acquires its indebtedness from a shareholder as a contribution to capital, section 118 does not apply, but such corporation is treated as having satisfied the debt with an amount of money equal to the shareholder's basis in the debt.

The proposal would be effective for contributions made and transactions entered into after the date of the enactment.

KPMG observation

Under current Code section 118, corporations do not recognize income on a receipt of a contribution to capital from a shareholder or a nonshareholder. A number of cases, including *U.S. v. Chicago, Burlington & Quincy R.R.*, 412 U.S. 401 (1973), describe the characteristics of a non-shareholder contribution to capital. Often, but not always, a nonshareholder contribution to capital consists of a grant to a corporate taxpayer from an instrumentality of the federal, state, or local government to encourage the taxpayer to invest within the government's jurisdiction or to invest in certain processes or technology (e.g., broadband infrastructure). In repealing section 118, the proposal would require corporate taxpayers to treat their receipt of such grants as taxable income.

While the discussion draft states that the intent of the proposal is to eliminate a federal tax subsidy for state and local incentives and concessions granted to corporations to incentivize them to locate operations within the grantor's jurisdiction, the proposal would apply to a contribution to capital regardless of its source or use by the recipient.

Also, the proposal would implement the nonshareholder contribution concept by applying the rule to a receipt of cash or property by a corporation when the value of the cash or property received exceeds the value of the stock, if any, issued in exchange therefor. This rule does not by its terms address the situation in which the transferee corporation does not issue stock because such an issuance would be a meaningless gesture. This could be the case, for example, for a transfer of property to the corporation by its sole shareholder or a transfer of property by each of a corporation's shareholders of an amount in proportion to their ownership of the corporation.

Further, it is unclear how the proposal would affect the application of *Freedom Newspapers, Inc. v. Commissioner,* 36 TCM (CCH) 1755 (1977). In that case, a purchaser of property received an inducement payment to undertake the acquisition. The court treated the purchaser's receipt of the payment as a reduction in the purchase price for the property acquired.

Modify net operating loss (NOL) deduction. A provision of the discussion draft (section 3106 of the draft legislation) would limit a corporation's NOL deduction to 90% of taxable income. This limitation on the use of the NOL is similar to the current limitation of NOLs in the alternative minimum tax (AMT) regime (which would be repealed under the discussion draft). These limitations would apply to (a) tax years beginning after December 31, 2014, and (b) carrybacks of NOLs arising in tax years beginning after December 31, 2014, to tax years beginning on or before such date.

The proposal also would repeal the special NOL carryback provisions other than the provision relating to certain casualty and disaster losses. Of particular note, the discussion draft would repeal the limitation on the carryback of excess interest losses attributable to corporate equity reduction transactions (CERTs). The repeal of the special carryback provisions would apply to losses arising in tax years beginning after December 31, 2014, and for certain expired provisions on the date of enactment.

KPMG observation

The proposed repeal of the CERT rules is particularly interesting in light of the attention these rules have received in recent years, including the September 2012 issuance of a comprehensive set of proposed regulations under the CERT rules.

Modify amortization of goodwill and certain other intangibles. A proposed provision (in section 3119 of the draft legislation) would extend from 15 years to 20 years the amortization period for acquired section 197 intangibles, which include purchased goodwill and going concern value, certain covenants not to compete, trademarks, trade names, and franchises. Also, acquired mortgage servicing rights would be amortized over 20 years, rather than over 108 months, as under current law.

These changes would apply to intangibles acquired after December 31, 2014.

Prevent transfer of certain losses from tax-indifferent parties. Current Code section 267(d) generally provides that if a loss on a sale or exchange of property to certain related parties or controlled partnerships has been disallowed under section 267(a)(1) or section 707(b), the transferee may reduce any gain that the transferee later

recognizes on a disposition of the property by the amount of the loss disallowed to the transferor. Thus, section 267(d) shifts the benefit of the loss to the transferee.

A provision of the discussion draft (section 3125 of draft legislation) would prevent the principles of Code section 267(d) from applying to the extent gain or loss with respect to property that has been sold or exchanged is not subject to U.S. income tax in the hands of the transferor immediately before the transfer but any gain or loss with respect to the property is subject to U.S. income tax in the hands of the transferee immediately after the transfer.

This change would apply to sales or exchanges after December 31, 2014.

KPMG observation

This proposal represents continued policing of the importation of built-in losses, covering related-party situations that may not already be covered by the anti-loss importation rules in section 362(e).

Repeal interest deduction limit on corporate acquisition indebtedness. A provision of the discussion draft (section 3127 of the draft legislation) would repeal Code section 279.

Under current law, section 279 generally denies a corporate interest deduction for interest in excess of $5 million on corporate acquisition indebtedness (i.e., generally, debt under certain subordinated obligations issued as consideration for the acquisition of stock or assets of another corporation).

This change would apply to interest paid or accrued on debt incurred after December 31, 2014.

Exchanges of debt instruments

Modify treatment of certain exchanges of debt instruments. The proposal (in section 3412 of the draft legislation) would provide new rules for determining the issue price of a new debt instrument in the case of an exchange of such new debt instrument for an existing debt instrument of the same issuer (including an exchange due to a "significant modification" under Reg. section 1.1001-3).

This change would apply to transactions entered into after December 31, 2014. For more information, see the Financial institutions and products discussion.

KPMG observation

This proposal may prevent certain corporations in financial distress from recognizing cancellation of indebtedness income when modifications to their debt constitute "significant modifications" that trigger a deemed exchange of new debt for the old debt.

Nonrecognition of derivative transactions by a corporation with respect to its stock. Pursuant to a proposed provision (section 3423 of the draft legislation), "Code section 1032 derivative items" would generally not be taken into account in determining a corporation's tax liability.

Under the proposal, a section 1032 derivative item of a corporation is an item of income, gain, loss, or deduction to the extent it arises from any rights or obligations under a derivative with respect to the corporation's stock or is attributable to the transfer or extinguishment of any such right or obligation.

A section 1032 derivative item is also an item of income, gain, loss, or deduction that arises under any other contract or position to the extent the item reflects or is determined by reference to changes in the value of the corporation's stock or distributions on the stock.

The proposal also would provide regulatory authority to treat section 1032 derivative items as contributions to capital that are includable in gross income to the extent not doing so would be inconsistent with new Code section 76, as added by the discussion draft.

In addition, the proposal would provide for income recognition on certain forward contracts as if the includible amounts were original issue discount. This rule would apply if a corporation acquires its stock as part of a plan or series of related transactions pursuant to which the corporation enters into a forward contract with respect to its stock. In this situation, the corporation would include in income the excess of the amount to be received under the forward contract over the fair market value of the stock as of the date the corporation entered into the forward contract. The income would be included as if the excess were original issue discount on a debt instrument acquired on that date. This rule of inclusion would apply only to the extent that the amount of the stock involved in the forward contract does not exceed the amount of stock acquired by the corporation pursuant to the plan or series of related transactions.

Under the proposal, a plan would be presumed to exist if a corporation enters into a forward contract with respect to its stock with the 60-day period beginning on the date 30 days before the date it acquires its stock.

This change would apply to transactions entered into after the date of enactment.

Passthrough provisions relevant to C corporations

Prevent tax-free spinoffs involving real estate investment trusts (REITs). A proposal (section 3631 of the draft legislation) would make a REIT ineligible to participate in a tax-free spin-off under Code section 355 as either a distributing or controlled corporation.

In addition, the proposal would prevent any corporation (or successor corporation) that was a party to a tax-free spin (either as the distributing or the controlled corporation) from electing REIT status for any tax year prior to the 10th tax year beginning after the tax year of the spin transaction.

This change would apply to distributions occurring on or after February 26, 2014, but would not apply to a distribution that occurs pursuant to an agreement that was binding on February 26, 2014, and at all times thereafter.

KPMG observation

While the discussion draft articulates the change in terms of the active trade or business requirement, the proposed statutory language merely says that section 355 would not apply to a distribution when the controlled corporation or distributing corporation is a REIT. This distinction may be relevant in a situation, for example, of a C corporation holding company that is relying on the activities of a captive REIT to satisfy the active trade or business requirement.

The discussion draft says this proposal would invalidate Rev. Rul. 2001-29, 2001-1 C.B. 1348, in which the IRS concluded that a REIT may satisfy the active trade or business requirement in section 355(b) though its rental activities. In any event, transactions such as the one described in PLR 201337007 (in which the IRS recently approved the tax-free spinoff under section 355 of real estate assets into a newly formed REIT) no longer would qualify under section 355. Taxpayers need to be aware of the proposed retroactive effective date.

Modify built-in gain recognition rules with respect to C corporation election to become a RIC or REIT. A proposed provision (section 3647 of the draft legislation) would require a C corporation that elects to become a REIT or RIC to recognize gain or loss as if all of its assets were sold at their fair market value immediately before the C corporation becomes a REIT or RIC. This rule would not apply if the C corporation would recognize a net loss. Similar rules would apply to certain transfers of assets by a C corporation to a REIT or RIC in carryover basis transaction.

This change would apply to elections or transfers occurring on or after February 26, 2014.

KPMG observation

The proposal would eliminate the election, currently permitted in Treasury regulations under Code section 337, for a C corporation electing REIT or RIC status to treat its built-

in gain as if the REIT or RIC were an S corporation subject to the rules of section 1374 (which generally imposes a corporate level tax on an S corporation's net recognized built-in gain that arose prior to the conversion of the C corporation to an S corporation and is recognized by the S corporation during a 10-year recognition period).

Taxpayers should be aware of the retroactive effective date if this provision as drafted becomes law.

For a more comprehensive overview, see the REIT and RIC provisions section.

Exclude dividends from controlled foreign corporations from the definition of personal holding company income

For purposes of the personal holding company tax, a proposed provision (section 3661 of the draft legislation) would exclude dividends received by a 10% U.S. shareholder (as defined in Code section 951(b)) from a controlled foreign corporation (as defined in section 957(a)) from the definition of personal holding company income.

Currently, personal holding company income includes dividends received from foreign subsidiaries, even if such dividends are derived from an active trade or business of the foreign subsidiary.

This change would apply to tax years beginning after December 31, 2014. For more detailed discussion of this provision, see Other provisions under the "Multinational entities" section.

Other corporate provisions

Repeal the AMT. A provision (section 2001 of the draft legislation) would repeal the individual and corporate AMT and generally allow taxpayers to claim remaining minimum tax credits in tax years beginning before 2020.

Unify rules for deduction of start-up and organizational expenditures. A proposed provision (section 3123 of the draft legislation) would consolidate the rules for start-up expenditures and organizational expenditures into a single provision that would generally permit a taxpayer to elect to deduct up to $10,000 of such expenditures in the tax year in which the active trade or business begins. The $10,000 amount would be reduced (but not below zero) by the amount by which the cumulative amount of such expenditures exceeds $60,000. The remainder of such expenditures would be amortized over a period of not less than 15 years. The revised rules would be consolidated in section 195, and sections 248 and 709 would be removed.

Repeal like-kind exchange rules. A provision (section 3133 of the draft legislation) would repeal Code section 1031, which currently provides nonrecognition treatment to certain "like-kind" exchanges. Note that the administration included in its proposed budget for fiscal year 2015 a proposal to limit the amount of gain deferred under section 1031 from

the exchange of "real property" to $1 million (indexed for inflation) per taxpayer per tax year. Thus, there appears to be an increased focus on section 1031 by lawmakers.

Repeal special rules for gain from certain small business stock. A provision of the discussion draft (section 3136 of the draft legislation) would repeal the exclusion in Code section 1202 for an individual's gain on the sale of small business stock. The proposal also would repeal Code section 1045, which permits an individual to elect to roll over gain from the sale of certain small business stock when other small business stock is purchased during the 60-day period beginning on the date of the sale.

Relocate definition of "C corporation". A proposed provision (section 3607 of the draft legislation) would move the definition of "C corporation" (i.e., a corporation other than an S corporation) from Code section 1361 to section 7701. The definition of the term "corporation" already is located in section 7701(a)(3).

Increase refund and credit threshold for JCT review of C corporation returns. A proposed provision (section 6105 of the draft legislation) would increase the threshold for JCT review of refunds or credits for corporate taxpayers from $2 million to $5 million. The $2 million threshold would continue for other taxpayers.

Provide new due date for C corporation Form 1120 and automatic six-month extension. A proposed provision (section 6201 of the draft legislation) would require C corporation returns on Form 1120 to be filed on or before the 15th day of the fourth month (instead of the third month under current law) after the close of a tax year (i.e., April 15 in the case of a calendar year taxpayer). A second provision (section 6203 of the draft legislation) would provide C corporations with an automatic six-month extension of the applicable filing date, which would codify certain extensions currently implemented in regulations. For more information, see the discussion of proposed due date changes.

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Accounting provisions

The discussion draft proposes changes to depreciation, amortization, and other cost recovery topics; would repeal several general business credits; and would make modifications to the low-income housing credit.

Reform the accelerated depreciation system

Under provisions of the discussion draft (sections 3104 and 3139 of the draft legislation), the accelerated depreciation provisions of the current Modified Accelerated Cost Recovery System (MACRS) would be repealed.

Tangible property placed in service after December 31, 2016, would be depreciated under rules similar to the current Alternative Depreciation System (ADS)—the straight-line method would be applied to the class life of each asset to determine the year's depreciation deduction.

The class lives would generally be those that have been used under current law. The Treasury Department would be charged with doing a study to update the class lives to better reflect the economic useful lives of the assets; a revised schedule of class lives could be implemented as early as 2018.

For some assets, recovery periods would be assigned in the statute, including:

- 5 years for computers, other qualified technological equipment, and automobiles and light trucks
- 12 years for airplanes
- 40 years for buildings and other real property without a class life
- 50 years for water treatment and utility property

Tax-exempt-use property that is subject to a lease would need to be depreciated over a recovery period no shorter than 125% of the lease term.

In addition to the depreciation deduction determined under these rules, a taxpayer could elect to take an additional deduction to reflect inflation in the value of its depreciable assets during the tax year. The additional deduction would be based on the "modified" adjusted basis of the asset at the end of each tax year, reflecting the regular depreciation for the year, but without any adjustment for prior additional depreciation deductions. The deduction would be equal to the modified adjusted basis multiplied by the change in the "chained CPI" for the previous year.[1] This additional deduction would

[1] **Chained CPI** is a measure of inflation that takes into account substitution—namely, the fact that consumers will change their buying patterns to reduce the effect of inflation. For example, when the price of beef rises, consumers may purchase a cheaper substitute, such as chicken. Thus, as consumers choose alternatives in the mix of goods they purchase, the aggregate amount of inflation they experience is affected. Chained CPI generally reflects a slower rate of inflation than the CPI index currently used for most tax indexing purposes.

reduce basis of the asset for other purposes. The election would need to be made for all eligible property placed in service by the taxpayer during each year, though a separate election could be made for each trade or business. Buildings would not be eligible for the additional deduction.

Most of the other computational rules under MACRS would remain in effect.

- The half-year, mid-quarter, and mid-month placed-in-service convention rules would continue to apply, though the mid-month convention for buildings would be applied also to additional real property and water treatment and utility property.
- The step-into-the-shoes rules would continue to apply to determine depreciation of property transferred in certain tax-free transactions (other portions of the discussion draft would repeal the technical termination rules for partnerships, which have been excluded from the step-into-the-shoes rules).
- Taxpayers would still be permitted to recognize a loss on leasehold improvements that are abandoned or disposed of upon the termination of a lease.
- Taxpayers would still be able to elect for any particular items of tangible property to use a depreciation method that is not expressed in a term of years, such as the units-of-production method.

The discussion draft would repeal bonus depreciation, as well as special rules for qualified leasehold improvements, qualified retail improvements, qualified restaurant property, solar and wind energy property, other alternative energy property, property used in research and experimentation activities, Alaskan natural gas pipelines, retail motor fuels outlets, second generation biofuel plant property, reuse and recycling property, and other items.

The current-law depreciation recapture rules would continue in effect to characterize a portion of the gain on disposition of a depreciable asset as ordinary income. However, the section 1250 recapture rule for real property would be expanded to make all depreciation deductions after December 31, 2014, potentially subject to ordinary income treatment, in addition to any depreciation in excess of the straight-line method in earlier periods.

The normalization rules for public utility property would be preserved. These rules under current law are intended to prevent a regulated taxpayer from using accelerated tax depreciation methods in computing its cost of service for ratemaking purposes. To address the excess tax reserves likely created by lower corporate tax rates, the discussion draft would discourage a taxpayer from reducing its excess tax reserve more rapidly or to a greater extent than if the average rate assumption method is used. A taxpayer that did not comply would be penalized with an increase in tax by the amount of the excess reduction in the excess tax reserve, for property placed in service after 2016.

Modify the income-forecast depreciation method

Under a provision of the discussion draft (section 3313 of the draft legislation), the income-forecast method of depreciating films, recordings, copyrights, patents, books and similar property, which is available at the taxpayer's election, would be revised to require depreciation to be matched to the anticipated income from the property over the 20-year period after it is placed in service, rather than the current 10 years.

Profit participations and residual payments agreed to in producing the property would no longer be counted as part of the depreciable basis, but would be deducted when paid.

Taxpayers could elect to depreciate any property eligible for the income-forecast method over 20 years using the straight-line method.

A rule that allowed certain musical works and copyrights to be amortized over five years, which expired in 2010, would be repealed. These changes would be effective for property placed in service after 2014.

Extend the amortization period for section 197 intangibles

Under a provision of the discussion draft (section 3119 of the draft legislation), the proposal would extend from 15 years to 20 years the amortization period for section 197 intangibles, which include purchased goodwill and going concern value, certain covenants not to compete, trademarks, trade names, and franchises.

Also, acquired mortgage servicing rights would be amortized over 20 years, rather than over 108 months as under current law. These changes would apply to intangibles acquired after December 31, 2014.

Extend safe-harbor depreciation period for certain intangibles

Under a provision of the discussion draft (section 3113 of the draft legislation), a regulatory rule that provides a 15-year safe harbor useful life for amortization of certain intangible assets that do not have a determinable useful life or prescribed recovery period, and are not section 197 intangibles, would be modified to require that a 20-year safe harbor life be used. This would be effective for property placed in service after 2014.

Modify the section 179 expensing election

Under a provision of the discussion draft (section 3111 of the draft legislation), the section 179 election would be modified to set a permanent $250,000 maximum limitation on the amount of business property that a taxpayer could deduct, rather than capitalize and depreciate, each year. This limitation would be reduced dollar-for-dollar as total investment exceeds $800,000. These dollar amounts would be adjusted for inflation.

Computer software would permanently be added to the eligible investments, as would heating and air conditioning units. Also, an existing temporary provision allowing a taxpayer to elect to treat building improvements that are characterized as qualified leasehold improvement property, qualified retail improvements, or qualified restaurant property as section 179 property would be made permanent. This election would apply to all such property placed in service in the same year and would be subject to the overall $250,000 limit.

Repeal special expensing or amortization rules for capital investments

Under provisions of the discussion draft (sections 3105, 3109, 3112, 3114, 3115, 3116, and 3121 of the draft legislation), several special rules allowing certain expenditures to be deducted instead of depreciated, or amortized rapidly, would be repealed.

Specifically, these provisions relate to:

- Production costs of domestic films and television shows
- Costs of energy efficiency improvements to commercial buildings
- Costs of certain pollution control facilities
- Soil and water conservation expenditures
- Endangered species recovery expenditures
- 50% of the costs of certain new oil refineries
- Costs of advanced mine safety equipment
- Farm fertilizer expenditures
- Business recovery costs related to pre-2010 disasters

Repeal election to amortize rather than expense certain expenditures

Under current law, taxpayers can elect each year to amortize any dollar amount of several types of expenditures for the tax year, rather than expense them, and have this elective amortization apply in computing both regular tax and AMT. For example, research and experimental expenditures can electively be amortized over 10 years, and intangible drilling costs can be amortized over 60 months (the election can also be applied to circulation expenditures and mining exploration and development expenditures).

A provision of the discussion draft (section 2001(d)(2) of the draft legislation) would repeal this provision. Elections for 2014 and earlier years would remain in effect, but no election could be made in 2015 and later years.

KPMG observation

Because the election can be applied each year to any dollar amount of any of the specified deductions, taxpayers have used this election to manage their taxable income with great precision, for example, to enable more NOLs to be used.

Eliminate various general business credits

Under provisions of the discussion draft (sections 3207, 3208, 3212, 3219, and 3229 of the draft legislation):

- The work opportunity credit would not be available for wages paid or incurred to employees who begin work after December 31, 2013.
- The credit for costs of substantially rehabilitating certain old or historic buildings would not be allowed for amounts paid after December 31, 2014. A transition rule would allow the credit for amounts paid through December 31, 2016, if the taxpayer acquired the building before January 1, 2015. Credits for such transition property would be available for rehabilitations completed through 2017.
- The credit for certain wages paid to members of Indian tribes who live and work on or near an Indian reservation would be repealed, for tax years beginning after 2013.
- The credit allowed to an employer for a portion of the Social Security tax paid on tips of certain employees in the food and beverage industries would be repealed for tips for services performed after 2014.
- The credit allowed for maintenance expenses of railroad track of a Class II or Class III railroad would be repealed, effective for tax years beginning after 2013.
- The credit for certain costs of training mine rescue teams would be repealed for tax years beginning after 2013.

KPMG observation

The discussion draft does not amend the rules allowing general business credits that cannot be used in the current tax year to be carried back one year and carried forward 20 years. Credits that were generated before the effective date of their repeal would continue to be available as carryovers in later tax years.

With the discussion draft's repeal of the AMT, the restriction on using general business credits against AMT or to reduce tax liability below the taxpayer's tentative minimum tax amount would be repealed. Taxpayers would still be limited to using their general business credits to offset their first $25,000 of regular tax liability, and 75% of the excess.

Repeal deduction for certain unused general business credits. Under current law, a deduction is allowed for all or a portion of certain credits whose carryover period expires, or if the taxpayer dies or ceases to exist before the end of the carryover period. Under a provision of the discussion draft (section 3230 of the draft legislation), no deduction would be allowed in tax years beginning after 2014, regardless of the year the credit was generated.

KPMG observation

This deduction for unused credits was, in most cases, allowed in situations when the taxpayer was required to include the amount of the credit allowed in taxable income. In effect, the deduction gave assurance that the taxpayer would receive some tax benefit for the economic outlay that generated the credit, even if the credit expired. With repeal, this tax benefit could permanently be lost. Most of the credits for which a deduction would be allowed would be repealed, but the research credit, for example, would continue to be subject to such an income adjustment, and in the future there would be no mechanism to make a tax benefit available if the credit expired unused.

Modify the low-income housing credit

The discussion draft includes a provision (section 3204 of the draft legislation) that would make significant changes to the low-income housing credit.

The credits for any project would be allowed over a 15-year period, rather than a 10-year period. As under current law, the annual credit would be an amount that provides total credits over the credit period with a present value equal to 70% of the adjusted basis of the building. There would be no additional period after the 15-year period in which the taxpayer is obliged to maintain the low-income qualifications, and there would be no recapture of prior credits if the project's qualified basis declined or it ceased to be qualified.

A temporary provision that has set the minimum credit percentage at 9% would be eliminated.

A smaller credit (the so-called "4% credit"), allowed for federally subsidized projects and buildings that are not new buildings, would be eliminated. Federally funded grants would not be taken into account in computing the adjusted basis of the remaining credit. An enhanced credit percentage available to buildings in high-cost areas would be repealed.

The allocations of low-income housing credit authority that each state is permitted would be based on an aggregate amount of adjusted basis for each state, rather than an aggregate amount of credits. A state's allocation each year would be the greater of $31.20 per state resident, or $31.3 million. These amounts would be adjusted for inflation starting in 2016. Several changes would be made to the requirements for allocating the per-state amount among applicants.

These changes would apply to amounts of adjusted basis allocations determined in calendar years after 2014, and to the credits arising from those basis allocations.

Limitation on use of cash method of accounting

Under the proposal, the cash method would be allowed only for taxpayers with average annual gross receipts of $10 million or less. Taxpayers with more than $10 million would be required to use the accrual method of accounting. Current-law exceptions would continue to apply for farming businesses and sole proprietors.

The provision would be effective for tax years beginning after 2014, and any positive adjustments to income resulting from the provision would be recognized in income in increasing increments over four years beginning in 2019 (or earlier, at the election of the taxpayer).

KPMG observation

The proposed provisions would deny the cash method to a broader range of taxpayers: e.g., personal service corporations, large partnerships that are able to use the cash method under current law because they have no inventory and no corporate partners, and others. According to the discussion draft, the provision is intended to strike a balance between ensuring that income is clearly reflected and respecting small-business taxpayers' need for simplicity.

Certain special rules for tax year of inclusion

Under this provision, a taxpayer on the accrual method of accounting for tax purposes would be required to include an item of income no later than the tax year in which such item is included for financial statement purposes. The provision also would provide that cash- and accrual-method taxpayers may defer the inclusion of advance payments for certain goods and services in income for tax purposes up to only one year (but not longer than any deferral for financial statement purposes).

Additionally, the provision would repeal special exceptions for crop insurance proceeds and disaster payments, livestock sales, and utility-restructuring transactions.

With some exceptions, the provision would be generally be effective for tax years beginning after 2014, with any adjustments resulting from accounting method changes taken into account over the four years beginning with the year of change.

KPMG observation

This provision would affect any item for which tax deferral is currently allowed past the time that the income is included for financial statement purposes—for example, credit card fees and loan fees treated as original issue discount.

Amortization of certain advertising expenses

Under the proposed provision, 50% of certain advertising expenses (over a $1 million threshold which would phase out starting at $1.5 million) would be currently deductible and 50% would be amortized ratably over a 10-year period. The provision would be effective for amounts paid or incurred in tax years beginning after 2014, but would be phased in for tax years beginning before 2018 as follows:

- For tax years beginning in 2015, 80% of advertising costs would be deductible and 20% amortized;
- For tax years beginning in 2016, 70% of advertising costs would be deductible and 30% amortized; and
- For tax years beginning in 2017, 60% of advertising costs would be deductible and 40% amortized.

For this purpose, advertising expenses would include any amount paid or incurred for development, production, or placement (including any form of transmission, broadcast, publication, display, or distribution) of any communication to the general public intended to promote the taxpayer's trade or business (including any service, facility, or product provided pursuant to such trade or business). In addition, advertising expenses would include wages paid to employees primarily engaged in activities related to advertising and the direct supervision of employees engaged in such activities.

Advertising expenses would not include:

- Depreciable property
- Amortizable section 197 intangibles
- Discounts
- Certain communications on the taxpayer's property
- Creation of logos (and trade names)
- Marketing research
- Business meals
- Qualified sponsorship payments

Under the proposed provision, no deduction of unamortized expenses would be allowed if any property with respect to which amortizable advertising expenses are paid or incurred is retired or abandoned during the 10-year amortization period. In addition, the current regulatory exception permitting the immediate deduction of package design costs would be repealed, and such costs would be capitalized into the cost of producing the packaging and recovered as the packaging and products within are sold.

The provision would be effective for amounts paid or incurred in tax years beginning after 2014.

KPMG observation

The JCT estimates that the advertising expense amortization provision would increase revenues by $169 billion from 2014 to 2023. Although the provision defines "advertising" for this purpose, there would undoubtedly be uncertainty and controversy about what costs fall outside its scope.

Installment sales

Under current law, sales accounted for on the installment method are subject to an interest charge on the resulting tax deferral to the extent that the taxpayer's aggregate installment sales exceed $5 million.

The proposed provisions would eliminate the $5 million aggregation rule and subject any installment sale in excess of $150,000 to the interest charge rules. Special rules related to the sale of farm property, timeshares, and residential lots would also be eliminated. The provision would be effective for sales and other dispositions after 2014.

Long-term contracts

Under the proposed provision, the completed contract method of accounting would be limited to construction contracts estimated to be completed within two years for taxpayers with average gross receipts of $10 million or less over a three-year period. Exceptions for the use of the percentage of completion method for multi-unit housing and ship-building contracts would also be repealed. The provision would be effective for contracts entered into after 2014.

KPMG observation

While existing law allows large construction companies that are home builders to benefit from using the completed contract method, the proposed provision would limit the application of the method to small business construction contractors.

Expenditures for repairs in connection with casualty losses

Under the provision, taxpayers could elect either to claim a casualty loss for damaged property (with a corresponding decrease to the property's basis) or to deduct the costs to repair such property, but not both. The provision would be effective for losses sustained after 2014.

KPMG observation

The discussion draft states that, under current law, taxpayers have taken the position that both a casualty-loss deduction and the deduction for amounts paid or incurred for

repairs may be claimed with respect to the same property damaged in a natural disaster. Recently issued final regulations under Code section 263(a) (effective for tax years beginning after 2013) provide a similar rule in that otherwise deductible repairs to property damaged in a casualty event must be capitalized to the extent of the adjusted basis of the damaged property. Proposed regulations relating to dispositions of tangible property would make the recognition of a casualty loss mandatory.

Repeal last-in, first-out (LIFO) inventory method

The proposal would repeal the use of the LIFO method for tax years beginning after December 31, 2014.

Taxpayers would be required to discontinue the use of the LIFO method and include the LIFO reserve in income as a section 481(a) adjustment. The section 481(a) adjustment would be taken into account over a four-year period beginning with the taxpayer's first tax year after 2018 in the following amounts:

- 10% in 2019;
- 15% in 2020;
- 25% in 2021; and
- 50% in 2022.

A taxpayer could elect to begin the four-year inclusion period in an earlier tax year. Special rules would apply for closely held entities (generally defined as having no more than 100 owners as of February 26, 2014), which would subject them to a reduced 7% tax rate on their LIFO reserves.

JCT has estimated that this provision would increase revenues by $79.1 billion from 2014 to 2023.

KPMG observation

The repeal of LIFO would have the effect of triggering the deferred tax liability inherent in the LIFO inventory accounting method. The transition rule, allowing delayed inclusion of the LIFO reserve over a four-year period, is intended to mitigate the impact of the inclusion.

Aside from the proposal, the International Financial Reporting Standards (IFRS) generally preclude the use of the LIFO method for financial reporting purposes. Taxpayers subject to IFRS must generally discontinue using the LIFO method as a consequence of the book conformity requirement. Taxpayers that must discontinue using LIFO as a result of IFRS would not receive the more favorable delay on including the section 481(a) adjustment that is included in the proposal.

Repeal lower-of-cost-or-market (LCM) inventory method

The proposal would repeal the use of the LCM method (inclusive of the write-down of subnormal goods) for tax years beginning after December 31, 2014. Any resulting positive section 481(a) adjustment would be taken into income over a four-year period beginning after 2018, as follows:

- 10% in 2019;
- 15% in 2020;
- 25% in 2021; and
- 50% in 2022.

The proposal would permit taxpayers to elect to begin the four-year inclusion period prior to 2019.

Modify rules for capitalization and inclusion in inventory of certain expenses

Under this proposed provision, the exception to the uniform capitalization (UNICAP) rules for businesses with average annual gross receipts of $10 million or less that acquire property for resale would be expanded to include all types of property (e.g., real property and tangible personal property), whether produced or acquired by the taxpayer.

In addition, the provision would repeal the special exceptions for timber and certain trees, and for freelance authors, photographers and artists. However, the provision's expanded exemption from the UNICAP rules for qualifying businesses would still apply in these cases.

These changes would be effective for tax years beginning after 2014.

JCT has estimated that this provision would reduce revenues by $4.5 billion from 2014 to 2023.

Repeal deduction for income attributable to domestic production activities

Under this proposed provision, the deduction for domestic production activities provided under section 199 would be phased out. The available deduction would be reduced to 6% for tax years beginning in 2015 and 3% for tax years beginning in 2016.

The deduction would be repealed and no longer available for tax years beginning after 2016.

KPMG observation

The original intent of the section 199 deduction was to provide a corporate rate reduction that would allow U.S. companies to compete against international tax systems, while also drawing international companies to the United States and its tax structure. While this proposed provision would eliminate the rate reduction created by

section 199, a separate provision of the discussion draft proposes an overall corporate rate reduction, as discussed above. JCT has estimated that repealing section 199 would increase revenues by $115.8 billion from 2014 to 2023.

Require capitalization and amortization of R&E expenditures

Under the proposed provision, all section 174 research and experimentation (R&E) expenses would be required to be capitalized and amortized over five years, beginning at the midpoint of the year paid or incurred.

Expenditures paid or incurred outside the United States, Puerto Rico, or a U.S. possession would be amortized over 15 years. The amortization period would continue regardless of whether there was a disposition of such property (i.e., retirement or abandonment).

Additionally, expenditures incurred for the development of software would be treated as section 174 R&E expenses and therefore subject to five-year amortization.

The provision would be effective for amounts paid or incurred in tax years beginning after 2014, and taxpayers would have the option of electing to apply the five-year amortization rule to all U.S. R&E expenses immediately, or phase it in as follows:

- For tax years beginning in 2015, a taxpayer could expense 60% and amortize 40% over two years.
- For tax years beginning in 2016-2017, a taxpayer could expense 40% and amortize 60% over three years.
- For tax years beginning in 2018-2020, a taxpayer could expense 20% and amortize 80% over four years.

KPMG observation

Existing law allows a taxpayer to currently deduct certain R&E expenditures paid or incurred in connection with a trade or business. Under the proposed provision, this provision would be considered repealed, as **all** R&E expenditures would be required to be capitalized and amortized. Additionally, although other sections of the discussion draft propose to remove software development expenses from qualification under the section 41 research credit (see discussion below), such software development expenses are includable as R&E expenses under section 174; however, such costs consequently would be subject to five-year amortization rather than current-year deduction.

Another provision in the discussion draft would repeal an election that allows a taxpayer to choose each year to amortize all or a portion of its R&E expenditures, rather than expensing them, over a 10-year period.

Deny deduction under section 174 for stock transferred under an incentive stock option (ISO)

Under this provision, the rules with respect to ISO plans and employee stock purchase plans (ESPPs) would be clarified to deny a deduction under any provision of the Code for a transfer of stock to an individual under such plans.

KPMG observation

Under current law, an employer that transfers stock to an individual pursuant to an ISO plan or ESPP may not claim a deduction as an ordinary and necessary business expense. Nonetheless, some taxpayers have taken the position that a deduction is permitted for wages paid with respect to R&E expenditures under section 174.

Modify and made permanent research credit

This proposed provision would modify and make permanent the research credit provided by section 41 and make the Alternative Simplified Credit (ASC) the only methodology available for calculating the credit. The general 20% credit would be repealed, as well as the 20% credit for amounts paid for basic research and the 20% credit for amounts paid to an energy research consortium.

Under this proposed provision, the research credit would equal:

- 15% of the qualified research expenses for the tax year that exceed 50% of the average qualified research expenses for the three tax years preceding the tax year for which the credit is determined, plus
- 15% of the basic research payments for the tax year that exceed 50% of the average basic research payments for the three tax years preceding the tax year for which the credit is determined.

The proposed provision would retain the rule under the ASC that allows a taxpayer a flat-rate reduced research credit if the taxpayer has no qualified research expenses in any one of the three preceding tax years. In these situations, taxpayers would be allowed a credit of 10% of the qualified research expenses incurred in the tax year for which the credit is determined.

This proposed provision would also make changes to the type and amount of certain costs that can be claimed as qualified research expenses. Amounts paid for supplies would no longer qualify as qualified research expenses. Also, any research with respect to computer software would not be qualified research.

In addition, the special rule allowing 75% of amounts paid to a qualified research consortium and 100% of amounts paid to eligible small businesses, universities, and federal laboratories to qualify as contract research expenses would be repealed. However, these amounts would still qualify as contract research expenses subject to the 65% inclusion rule.

Finally, this provision would repeal the election under section 280C(c) to claim a reduced research credit in lieu of reducing deductions otherwise allowed.

These changes would be effective for tax years beginning after 2013, and for amounts paid and incurred after 2013.

KPMG observation

Making the ASC the only methodology available for calculating the research credit is generally expected to reduce the administrative burdens and controversy associated with the general credit methodology. Further, a permanent research credit would provide businesses with greater certainty of available tax incentives when considering investments in research and development.

This proposed provision would eliminate the 20% credit provided under the general methodology while only increasing the credit available under the ASC methodology from 14% to 15%. Given this and the proposed removal of certain expenditures such as supplies from the research credit calculation, taxpayers that have historically used the general credit methodology may experience significant decreases in their research credit amounts as a result of moving to the ASC.

Repeal credit for clinical testing expenses for certain drugs for rare diseases or conditions

The discussion draft proposal would repeal the "orphan drug tax credit." The provision would be effective for amounts paid or incurred in tax years beginning after 2014.

KPMG observation

Qualifying clinical testing expenses that would have otherwise qualified under the orphan drug credit may be eligible as qualifying research expenses under Code section 41. Furthermore, certain taxpayers may, if the provision is enacted, find benefit under the section 41 credit where they had not in the past. Such taxpayers generally are those who had greater benefit under the orphan drug credit (and therefore did not claim a section 41 credit for those expenses) or who failed to generate a section 41 research credit as result of an inflated base amount (due to the requirement to add back orphan drug credit expenses to the section 41 base amount).

The orphan drug credit has been allowed for some clinical testing expenses outside the United States, if there is an insufficient testing population in the United States. These foreign expenses would not qualify under the research credit.

Other provisions

The discussion draft proposal also includes provisions that would:

- Codify the IRS guidance with respect to determining whether a taxpayer has adopted a method of accounting (i.e., use in one tax year for a proper method, use on two

consecutive returns for an improper method)

- Repeal the special rules for deferral of prepaid subscription income and prepaid membership dues
- Repeal the special rule for exclusion from gross income of magazines, paperbacks, and records returned after the close of the tax year
- Codify the judicial standards for determining the treatment of patent or trademark infringement awards—i.e., damages constitute ordinary income relating to lost profits unless the taxpayer can demonstrate that such payments reflect damages relating to impairment of capital (i.e., goodwill)
- Allow for recovery of environmental remediation costs ratably over 40 years beginning with the tax year paid or incurred
- Allow for recovery of circulation expenditures for newspapers, magazines, or other periodicals over 36 months
- Unify the deduction for start-up and organization expenditures, and increase the first-year deductible amount to $10,000.
- Repeal the recurring-item exception for spudding of oil and gas wells
- Repeal the special rules for recoveries of damages from antitrust violations
- Repeal the deduction for local lobbying expenses
- Repeal the special 20% tax rate for nuclear decommissioning reserve funds
- Repeal the averaging to compute tax liability of farming income
- Repeal redundant rules with respect to the election to capitalize taxes and carrying charges under section 266
- Repeal the provisions relating to empowerment zones and enterprise communities, DC Zones, renewal communities, and various short-term regional benefits
- Repeal the qualifying therapeutic discovery project credit
- Repeal section 118 (regarding exclusion of non-shareholder contributions to capital)
- Modify the NOL rules
- Extend the amortization period for section 197 intangibles
- For more information, contact a tax professional with the Tax and Accounting group of KPMG's Washington National Tax:

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Partnership and S corporation provisions

The discussion draft includes proposed changes to the income tax rate structure, the employment tax rules applicable to passthrough entities, the subchapter K and subchapter S rules, the publicly traded partnership (PTP) rules, and other provisions relevant to passthrough entities. If enacted, these provisions would significantly change the taxation of partnerships and S corporations and would affect choice-of-entity decisions.

This section focuses only on passthrough entities that are treated as partnerships or S corporations for federal income tax purposes. For more information, see the discussion of provisions affecting REITs and RICs.

Income tax rate structure

Under the discussion draft, C corporations would continue to be subject to two levels of income tax (i.e., at the corporate level as income is earned and at the shareholder level when income is distributed). In addition, S corporations and partnerships would continue to generally be subject to tax only at the owner level.[2] However, the corporate income tax rate would phase down to 25% over a five-year period,[3] while the marginal income tax rate many "high-income" owners of partnerships and S corporations would pay with respect to their shares of passthrough ordinary income could range from 25% to 38.8%, depending on the nature of the passthrough entity's activities and the level of the owner's participation.

The potential significant disparity between corporate income tax rates and individual income tax rates in certain situations could make partnership or S corporation status less attractive in those situations than under current law. Other changes in the income tax and employment tax rules would also be relevant to the choice-of-entity analysis. The discussion below highlights how some of the individual income tax rate changes could affect choice-of-entity decisions.

Individual rates, in general. In brief, the discussion draft would repeal the individual AMT and would reduce the current seven individual income tax brackets to three brackets: (1) a 10% bracket on taxable income up to $35,600 for single filers and taxable income up to $71,200 for joint filers; (2) a 25% bracket on taxable income in excess of those amounts; and (3) a 35% bracket resulting from a 10% surtax on modified adjusted gross income (MAGI) in excess of certain thresholds ($400,000 for single filers and $450,000 for joint filers). For more details on the proposed individual rate changes, see the Individual income tax section.

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[2] There are limited situations in which S corporations can be subject to two levels of tax under current law (e.g., the built-in gains tax, the passive investment income tax, and the LIFO recapture tax).

[3] The corporate AMT would also be repealed.

MAGI would include a number of items that are not included in adjusted gross income under current law.[4] From a passthrough perspective, it is important to note that MAGI would be decreased by qualified domestic manufacturing income (i.e., net income attributable to domestic manufacturing gross receipts).[5] Domestic manufacturing gross receipts generally would include gross receipts derived from (1) any lease, rental, license, sale, exchange, or other disposition of tangible personal property that is manufactured, produced, grown, or extracted in whole or in significant part within the United States, or (2) construction of real property in the United States as part of the active conduct of a construction trade or business. Thus, an individual's marginal income tax rate on his or her share of income from an S corporation or partnership would depend on whether or not such income constituted qualified domestic manufacturing income. A Ways and Means staff summary of the discussion draft (the "staff summary") explains that "excluding qualified domestic manufacturing income from the 35-percent bracket" would ensure that S corporations and partnerships "engaged in such activity are taxed at a rate no higher than 25%, achieving parity with C corporations under the Discussion Draft."

Net investment income tax. The discussion draft would not repeal the current 3.8% net investment income tax. Thus, a "passive" individual owner of a partnership or S corporation could be subject to an additional 3.8% tax on flowthrough income—raising the marginal rate on a "high-income" owner's share of such income to 28.8% (in the case of qualified domestic manufacturing income) or 38.8% (in the case of other income).

Capital gains and dividends. Under the discussion draft, long-term capital gain and qualified dividend income would no longer be subject to a preferential income tax rate. Instead, non-corporate taxpayers would be allowed to deduct 40% of their net capital gain and qualified dividend income from gross income. Net capital gain and qualified dividend income, however, would be taken into account in MAGI in computing the surtax. In addition, as noted above, the 3.8% tax on net investment income would continue to apply.

KPMG observation

Under the discussion draft, the marginal rate high-income owners would pay on their shares of business income from S corporations and partnerships would vary depending upon whether the income was attributable to domestic manufacturing gross receipts and whether the owner was subject to the net investment income tax on passthrough

[4] For example, employer-provided health benefits, tax-exempt interest, untaxed Social Security benefits, and certain other items would be included in MAGI.

[5] Charitable contributions could also decrease MAGI.

income. For example, an "active" owner of a passthrough entity that is engaged in constructing real property in the United States could be subject to a marginal income tax rate of 25% on flowthrough business income—i.e., the same rate that a C corporation would pay on that income. However, an owner of a passthrough entity in a service, retail, or wholesale business could pay tax on his or her share of service income at a marginal rate of 35% or 38.8% (depending on his or her level of participation in the business). Thus, some businesses that do not generate significant amounts of qualified domestic manufacturing income may find passthrough status less attractive relative to C corporation status than under current law, particularly if they do not plan to distribute earnings in the future.

Employment tax rules for partnerships and S corporations

The discussion draft also would make changes to the employment tax rules that could be expected to affect some choice-of-entity analyses. In this regard, the discussion draft would change the self-employment tax rules to treat an S corporation shareholder's share of nonseparately computed income from any trade or business conducted by the S corporation as net earnings from self-employment. Further, it would repeal the current-law exception (contained in section 1402(a)(13)) to the definition of net earnings from self-employment for the distributive share of "limited partners," other than guaranteed payments for services. Then, it would allow S corporation shareholders and partners (including members of LLCs) a new deduction intended to approximate a return on invested capital. According to the staff summary:

> The effect of the deduction would be that partners and S corporation shareholders who materially participate in the trade or business of the partnership or S corporation would treat 70% of their combined compensation and distributive share of the entity's income as net earnings from self-employment (and thus subject to FICA or SECA, as applicable) and the remaining 30% as earnings on invested capital not subject to SECA. For partners and S corporation shareholders who do not materially participate in the trade or business (i.e., passive investors), the effect of the deduction would be that no amount would be treated as net earnings from self-employment.

For this purpose, material participation would be determined based on the section 469 passive activity rules.

KPMG observation

This provision presumably is intended to clarify the employment tax treatment of members of LLCs (and certain other legal entities classified as partnerships) and to

prevent perceived abuses of the employment tax rules by shareholders of some service S corporations. Nonetheless, the proposal applies to all S corporations, not just S corporations engaged in service businesses. Further, the formula for imputing employment income is arbitrary and, therefore, may not necessarily reflect the proper allocation of income as attributable to labor versus capital in all situations. In any event, subjecting 70% of an "active" owner's distributive share of passthrough income to employment taxes would be yet another factor to be taken into account in choice-of-entity decisions.

Other changes to subchapters S and K, including new carried interest provision

In March 2013, the Ways and Means chairman released a discussion draft of tax reform proposals relating to partnerships and S corporations (the "2013 passthroughs draft), which included two options with respect to S corporations and partnerships. The first option would have modified the current regimes for partnerships and S corporations. The second option would have replaced the current rules for partnerships and S corporations with a single unified regime. The second option generated significant negative feedback. The discussion draft generally follows the first option, with some significant additions, including a carried interest provision. The discussion below addresses the carried interest provision first, and then summarizes some of the other changes to the partnership and S corporation rules.

Carried interest provision. The discussion draft would recharacterize a portion (and, in some situations, all) of a service partner's share of partnership income as ordinary based on a formula designed to approximate the compensation earned by the service partner for managing the partnership's capital. More specifically, the service partner's defined share of partnership capital would be multiplied by a specified rate of return (the federal long-term rate plus 10 percentage points). This calculation would produce a number (the "recharacterization account balance") that would establish the amount of partnership income that could be allocated to the service partner as ordinary income under the provision. The provision also would provide rules for distributions and dispositions of applicable interests. The carried interest provision would apply to a partnership engaged in a trade or business conducted on a regular, continuous, and substantial basis consisting of: (1) raising or returning capital; (2) identifying, investing in, or disposing of other trades or businesses; and (3) developing such trades or businesses. Although not stated in the proposed statutory language of the discussion draft or JCT's technical explanation of the discussion draft, the staff summary indicates that the provision would not apply to a partnership engaged in a real property trade or business.

KPMG observation

The discussion draft takes a different approach from carried interest proposals that previously have been introduced. Providing an apparent exception for partnerships engaged in a real property trade or business also represents a significant departure from previous carried interest proposals.

The previous proposals were based on the model originally proposed in 2007. Those proposals essentially presumed that all income allocated to a partner providing specified services to an investment partnership would be taxed at ordinary income rates except to the extent the partner could prove, under a narrow rule relating to qualified capital, that a portion of the partner's return was attributable to invested capital. In other words, any income allocated to the service partner that could not be properly traced to a qualified capital interest was presumed to be properly attributable to services and hence taxable at ordinary income rates.

Although not explicitly stated, the discussion draft appears to follow a model suggested by certain commentators whereby the general partner is presumed to borrow from the other partners an amount equal to the partnership capital that is used to fund the general partner's share of profit. Because no interest is charged on the borrowed capital, interest is effectively imputed to the general partner on the amount deemed borrowed. Under the discussion draft, the imputed interest in effect is used to establish a "recharacterization account balance," and partnership income allocated to the general partner is treated as ordinary income to the extent of the "recharacterization account balance." An analogous approach has been proposed in certain articles, including the following: Fleischer, *Two and Twenty: Taxing Partnership Profit in Private Equity Funds,* 83 N.Y.U L. Rev. 1 (2008), and Cunningham and Engler, *The Carried Interest Controversy: Let's Not Get Carried Away,* 61 Tax L. Rev. 121 (2008).

As a very simple example, if the general partner is entitled to 20% of partnership income, the general partner effectively is treated as borrowing 20% of the partnership's "invested capital." A stated interest rate is imputed based on the borrowed capital, while the interest that is deemed accrued establishes the amount of partnership income allocated to the general partner that may be treated as ordinary. While simple in concept, the rules attempting to carry out this model are very complicated and the discussion draft arguably may overestimate significantly the amount that would be properly attributed under a more precise interest imputation model that is tailored to the specific economic arrangement.

For more in-depth analysis of the carried interest provision, see the Appendix.

Change subchapter K rules. The discussion draft also would make other changes to the subchapter K rules. With the exception of the first three items described below, these items were included in the 2013 passthroughs draft:

- Repeal the technical termination rules contained in current section 708(b)(1)(B). As a practical matter, although technical terminations sometimes can have favorable results, they also can result in unfavorable tax consequences and additional compliance burdens. Thus, some partnerships may view repealing the technical termination rules as a favorable development.
- Clarify that a person is treated as a partner in a partnership in which capital is a material income-producing factor regardless of whether such interest is obtained by purchase or gift and regardless of whether it is acquired from a family member. JCT's technical explanation of the discussion draft indicates that the "determination of whether the owner of a capital interest is to be taxed on the income from the capital interest is to be made under the generally applicable rules defining a partnership and a partner." This provision appears to be intended to clarify legislatively that the argument made by the taxpayer in *Castle Harbor* (aka *TIFD III-E v. U.S.*) regarding who is treated as a partner for federal income tax purposes under 704(e) is not valid. *TIFD III-E v. United States*, 459 F3d 220 (2d Cir. 2006), *rev'g and remanding* 342 F.Supp. 2d 94 (D.Conn 2004).
- Replace current partnership audit procedures with a system of centralized audit, adjustment, and collection of tax, and would make other changes to partnership audit rules. (See Partnership audits and adjustment for more details.)
- Repeal the section 707(c) guaranteed payment rules. As a result, payments by a partnership to a partner would be treated either as nonpartner capacity payments under section 707(a) or as distributions under section 731. It appears that this change might facilitate the dual-status treatment of a person as both a partner and an employee, which treatment currently is prohibited under IRS guidance.
- Repeal both the section 736 rules for payments made in liquidation of a retiring or deceased partner's interest and the section 735 income in respect of a decedent (IRD) rules. As a result, payments made to retiring partners and successors-in-interest to deceased partners would be subject to the federal income tax rules generally applicable to the transaction, the provisions of subchapter D relating to payments under deferred compensation plans, and the general rules applicable to IRD.
- Make adjustments to the basis of partnership property mandatory for all distributions of partnership property to partners and transfers of partnership interests (including in the case of electing investment partnerships and securitization partnerships). The calculation of basis adjustments related to distributions of partnership property would be modified as well.
- Require lower-tier partnerships to make corresponding basis adjustments when basis adjustments are required with respect to distributions and transfers by upper-tier partnerships.

- Modify the section 704(d) loss limitation rules to provide that a partner's distributive share of non-deductible items that are not properly chargeable to capital account would be allowed only to the extent of the partner's basis in its partnership interest at the end of the partnership tax year in which the expenditure occurs.
- Modify the "hot asset" rules (1) to remove the requirement that inventory be "substantially appreciated" in the case of partnership distributions and (2) to provide that "unrealized receivables" include any property other than inventory but only to the extent of the amount that would be treated as ordinary income if the property were sold for fair market value.
- Eliminate the seven-year time limitation in the "anti-mixing bowl" rules of sections 704(c) and 737. As a result, a partner that contributes appreciated property to a partnership could recognize pre-contribution gain if the partnership distributed the contributed property to another partner, or distributed to the contributing partner other property (the value of which exceeds the partner's basis in its partnership interest), regardless of when the distribution occurs.

Change subchapter S rules. The discussion draft would make a number of favorable changes to the existing subchapter S rules. Specifically, the discussion draft would:

- Shorten the built-in gains tax recognition period for S corporations to five years on a permanent basis (see discussion of treatment of REITs and RICs)
- Increase the current threshold above which an S corporation's "excess net passive investment income" is subject to the corporate-level "sting" tax from 25% to 60% of gross receipts
- Repeal the provision that causes an S corporation election to terminate if the corporation has excess passive investment income and C corporation earnings and profits for three consecutive years
- Allow nonresident aliens to be potential current beneficiaries of electing small business trusts (ESBTs)
- Allow an ESBT's charitable contribution deduction to be determined by the rules applicable to individuals
- Make permanent the special rule for adjusting the basis of S corporation stock when S corporations make charitable contributions of property
- Allow an S corporation election to be filed not later than the extended due date of the corporation's return for the tax year
- Allow the IRS to treat a late revocation of S corporation status as timely if there were reasonable cause for the failure to have timely filed the revocation.

KPMG observation

The above amendments to subchapter S would need to be taken into account, along with the income tax rate changes and the employment tax changes, in comparing the consequences of being taxed as an S corporation or a C corporation.

Limitations on types of PTPs

The discussion draft would change the definition of "qualifying income" for purposes of the PTP rules so that only certain mining and natural resources PTPs could be treated as partnerships (rather than corporations). Thus, financial services PTPs would have to be classified as corporations for federal tax purposes. In addition, the discussion draft excludes income from fertilizer and timber from the definition of qualifying income, and omits current law language (which was added in 2008) relating to income from the transportation or storage of ethanol and other renewable fuels. Thus, it appears that some natural resources PTPs no longer would be able to be taxed as partnerships under the discussion draft.

Other provisions

The discussion draft would change the due dates for returns of partnerships, S corporations, and C corporations. Further, as discussed elsewhere in this analysis, it would make sweeping changes to individual and business taxation that could be relevant to passthrough entities, such as repealing a variety of business-related exclusions, deductions, and credits; substantially changing the cost recovery rules; repealing like-kind exchange treatment; repealing section 108(e)(6); narrowing the scope of the section 267(d) loss deferral rules in certain cases; limiting the use of the cash method of accounting; repealing the LIFO method; and changing the foreign tax rules.

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REIT and RIC provisions

The discussion draft proposes changes to the tax treatment of REITs and RICs.

REIT spin-off transactions

A provision in the discussion draft (section 3631 of the draft legislation) would prevent a spin-off transaction from qualifying for tax-free treatment, if either the distributing corporation or the controlled corporation is a REIT.

The proposal also prevents any corporation (or successor corporation) that was a party to a tax-free spin (either as the distributing or the controlled corporation) from electing qualified REIT status for any tax year prior to the 10th tax year beginning after the year of the spin transaction.

KPMG observation

This provision of the proposal would effectively overturn Rev. Rul. 2001-29, 2001-1 C.B. 1348, in which the IRS concluded that a REIT could satisfy the active trade or business requirement in section 355 for tax-free spin-off transactions.

The proposal would apply to distributions made on or after February 26, 2014, but would not apply to any distribution made pursuant to an agreement that was binding on such date and at all times thereafter.

Extend REIT disqualification period

Under current law, if a REIT election is terminated or revoked, the entity (and any successor entity) generally cannot re-elect qualified REIT status for a period of five years. A provision of the discussion draft (section 3632 of draft legislation) would extend this period from five years to 10 years. The provision would apply to terminations and revocations occurring after 2014.

Short-lived property not treated as real property for REIT purposes

Under a provision of the discussion draft (section 3633 of the draft legislation), the term "real property" would not include any tangible assets that have a class life that is less than 27.5 years. The provision would apply to tax years beginning after December 31, 2016.

KPMG observation

If enacted, this provision would prevent numerous categories of assets, which historically have been classified as real property, from qualifying as real property for REIT purposes.

Thus, assets such as outdoor billboard structures, land improvements (e.g., roads, berms, sidewalks, shrubbery, wharves, docks, bridges, and fences), transmission towers, service stations, gas pipelines and storage, and railroad tracks would not be treated as real property for REIT qualification purposes.

The provision would not apply to intangible assets. Presumably, certain types of goodwill that the IRS has ruled may be treated as real estate assets would not be affected by this provision. It is uncertain how the provision would apply to a leasehold interest in a short-lived tangible asset.

Timber REITs

Under a provision of the discussion draft (section 3634 of the draft legislation), timber would be specifically identified as not constituting real property for purposes of the REIT rules.

Also, certain conforming amendments would be made to remove timber-related provisions, such as striking the prohibited transaction safe harbor with respect to timber and certain temporary provisions favorable to timber REITs enacted as part of the *Heartland, Habitat, Harvest, and Horticulture Act of 2008*.

These amendments would be effective with respect to tax years beginning after December 31, 2016.

KPMG observation

Another provision of the discussion draft (section 3132 of the draft legislation) would repeal the special rules under Code section 631 for gain or loss on timber, coal, or domestic iron ore under Part III of subchapter I. According to JCT's description of the discussion draft, the effect of repealing section 631 would result in treating income from the disposal of timber as ordinary income, and the exclusion of timber from the definition of "real property" would be "consistent with the repeal of capital gain treatment for sales of standing and cut timber."

In *Hutchins v. King,* 68 U.S. 53 (1863), the Supreme Court stated that "timber growing upon the land constituted a portion of the realty." In *Laird v. United States,* 115 F. Supp. 931, 933 (W.D. Wis. 1953), the court stated "[g]rowing timber under the common law, the law of Canada, and the law of Wisconsin and of the United States, has always been considered a portion of the real property…."

Furthermore, for purposes of the Foreign Investment in Real Property Tax Act (FIRPTA), the term "real property" is defined under Reg. section 1.897-1(b)(2) to include timber until it is severed from the land.

If the discussion draft provision were to be enacted, timber would be another area of tax law for which varying tax results may be expected for different taxpayers and purposes. See the "Energy and natural resources" section for more detailed analysis of discussion draft proposals concerning natural resources and the timber and mining industries.

Fixed percentage rents and interest

The discussion draft (section 3635 of the draft legislation) provides that rents or interest based on a fixed percentage of receipts or sales would not be treated as qualifying income if the amounts are received from a single C corporation tenant or borrower (other than a taxable REIT subsidiary of the REIT) and the amounts represent 25% or more of the total fixed percentage rents or interest that the REIT receives.

For purposes of this rule, all members of an affiliated group (determined by substituting 50% for 80% in Code section 1504) would be treated as a single C corporation. The rule would apply to leases or mortgages entered into or acquired after December 31, 2014.

A material modification of a lease or mortgage would be treated as a new acquisition.

KPMG observation

The proposal would prevent, inter alia, the organization of new REITs that rely on one or a few tenants (or borrowers) for all their income, when a portion of the rents or interest receipts are participating (i.e., based on a percentage of sales or receipts). It would also apply to lease renewals or debt modifications of existing REITs that have this business model.

Similar to the REIT spin-off proposals, this proposal appears to target transactions in which the real estate of an operating C corporation is separated into a REIT and leased back to the operating company—though the proposal's actual application may extend well beyond this scenario.

Importantly, the proposal would not apply to lodging or healthcare companies that take advantage of the special rules that permit them to lease their properties to their own taxable REIT subsidiaries. The proposal also would not apply when the maximum percentage rents (or interest) received from a "single" tenant or borrower (including affiliates) do not exceed 25% of the REIT's total percentage-based receipts.

Note, however, that the 25% threshold compares the percentage-based amounts received from a single tenant to the total percentage-based receipts of the REIT, and not to the total income of the REIT. Consequently, if a REIT receives any percentage-based rents from a single C corporation, but receives no percentage-based rents from any of hundreds of other unrelated tenants, the percentage receipts from the C corporation would be treated as non-qualifying income.

The proposal also would apply only when the tenant or borrower is a C corporation. It is unknown whether the provisions would apply to a partnership lessee or borrower if one or more partners were C corporations.

Repeal preferential dividend rules for public REITs

Under the discussion draft (section 3636 of the draft legislation), the preferential dividend rule (under Code section 562(c)) would not apply to distributions by a publicly offered REIT in tax years beginning after December 31, 2014. For this purpose, a publicly offered REIT would be a REIT that is required to file annual and periodic reports with the Securities and Exchange Commission under the Securities Exchange Act of 1934.

KPMG observation

The *Regulated Investment Company Modernization Act of 2010* repealed the preferential dividend rule for publicly offered RICs. A similar repeal proposal was included recently in both the administration's FY 2014 revenue proposals and the *Update and Streamline REIT Act of 2012* (H.R. 5746). This repeal would have negligible revenue effect.

REIT distribution failures

Under the discussion draft (section 3637 of the draft legislation), with respect to distributions in tax years beginning after December 31, 2014, the Treasury Secretary would have the authority to provide an appropriate remedy to cure a preferential dividend distribution in lieu of disallowing the dividends paid deduction if the Secretary determines that the preferential distribution is inadvertent or is due to reasonable cause and not due to willful neglect.

KPMG observation

Reg. section 1.562-2(a) provides in part "[t]he limitation imposed by section 562(c) is unqualified," and "[t]he disallowance, where any preference in fact exists, extends to the entire amount of the distribution and not merely to a part of such distribution."

That is, there are no exceptions for de minimis or inadvertent violations. If the repeal with respect to publicly offered REITs is enacted, the preferential dividend rule would still remain relevant because of the widespread use of private REITs for ownership and operation of real estate located in the United States.

Dividend designations by REITs

Under the discussion draft (section 3638 of the draft legislation), the aggregate amount of capital gain dividend and qualified dividend income designated by a REIT with respect to distributions in a tax year beginning after December 31, 2014, would be limited to the dividends paid by the REIT with respect to such year.

Further, the Secretary could prescribe regulations or other guidance requiring the proportionality of the designation of particular types of dividends among shares or beneficial interests of a REIT.

KPMG observation

In Rev. Rul. 2005-31, 2005-1 C.B. 1084, the IRS ruled that, in making the dividend designations permitted by Code section 852(b)(3)(C) and (b)(5)(A), section 854(b)(1) and (2), and section 871(k)(1)(C) and (2)(C), a RIC may designate the maximum amount permitted under each provision even if the aggregate of all of the amounts so designated exceeds the total amount of the RIC's dividend distributions.

Rev. Rul. 2005-31 was referenced in JCT's *Description of Revenue Provisions Contained in the President's Fiscal Year 2012 Budget Proposal* with respect to discussions concerning both RICs and REITs. Thus, presumably, Rev. Rul. 2005-31 was the source of the concern prompting the proposed limitation on a REIT's overall designation of special character dividends.

With respect to the proportionality requirement in the discussion draft—cf. Rev. Rul. 89-81, 1989-1 C.B. 226, in which the IRS ruled that a RIC's designation of distributions (e.g., capital gain dividend or dividends qualifying for the dividends received deduction) had to be on a proportionate basis between the two classes—the discussion draft would limit the total special dividend designations to the amount of dividends actually paid, including dividends paid after the end of the year that are subject to a section 858 election (which gives the REIT a dividends paid deduction in the prior year for such distributions). The discussion draft does not state whether "deemed capital gain dividends" (i.e., when shareholders are taxed on undistributed capital gains pursuant to section 857(b)(3)(D)), would be considered an amount "paid" for purposes of this new rule.

E&P purges

The discussion draft (section 3639 of the draft legislation) generally would require that distributions made in order to comply with Code section 857(a)(2)(B) must be made in cash.

Section 857(a)(2)(B) requires a REIT to distribute or purge accumulated earnings and profits (E&P) earned during "non-REIT years"—e.g., when a taxable corporation with accumulated earnings converts to a REIT.

The provision would apply to distributions made on or after February 26, 2014.

KPMG observation

In numerous recent transactions in which new REITs had significant carryover E&P from a taxable C corporation(s), the REITs used taxable stock dividends to satisfy the E&P purging requirement. Under the proposed change, such purges would be required to be made in cash, which could be a significant impediment to completing a conversion transaction.

In addition to simple REIT conversions, the proposed provision would apply to any situation in which a REIT inherits accumulated earnings from a C corporation. This could include, for example, a merger of a taxable C corporation and a REIT, a tax-free liquidation of a taxable REIT subsidiary into a REIT, and a tax-free spin-off of a REIT from a C corporation.

The cash purge requirement would apply only to distributions made during a "transition period." For these purposes, the term "transition period" would be defined to mean the

> …period of taxable years beginning with the last taxable year (other than a short taxable year) which was a non-REIT year * * * and ending with the first taxable year to which the provisions of this part [i.e., the REIT rules] apply.

Thus, it would appear that the transition period would be intended to include the last 12-month tax period of the C corporation and extend through the REIT's first tax year.

Debt of publicly offered REITs and certain secured debt

The discussion draft (section 3640 of the draft legislation) would treat debt instruments (that do not otherwise qualify as real estate assets) issued by publicly offered REITs as qualified real estate assets. In addition, this proposal would expand the definition of real estate assets to include mortgages on "interests in real property," as well as mortgages on real property. The provisions would apply to tax years beginning after December 31, 2014.

KPMG observation

The practical benefit of the proposed changes may be narrower than it first appears. Although the proposal purports to treat public REIT debt instruments as real estate assets, it also states that income from such instruments (if not secured with a mortgage) would not qualify for the REIT 75% gross income test (real estate-sourced gross income). Further, unlike other qualified real estate assets, the proposal provides that these REIT debt instruments may not account for more than 25% of a REIT's total assets.

Under current law, a REIT is already permitted to hold non-mortgage debt securities of another REIT, provided they do not exceed 25% of the REIT's assets (when aggregated with other non-real-estate securities held by the REIT) and the securities of any single issuer held by the REIT do not exceed 5% of its total assets. Thus, the practical effect of the proposal to treat public REIT debt securities as real estate assets is that such instruments would no longer be subject to the single-issuer 5% limitation. In addition,

these REIT securities would be subject to a separate 25% limitation for which they would not be aggregated with non-REIT securities.

Expanding the definition of real estate assets to include mortgages on interests in real property (in addition to mortgages on real property) simply would conform the asset definition with what has always been the rule for the gross income tests.

Treatment of ancillary personal property

Under the discussion draft (section 3641 of the draft legislation), personal property ancillary to real property (applying the 15% personal property rent test) would be treated as a real estate asset for purposes of the asset holding requirements.

Further, for an obligation secured by a mortgage on both real property and personal property, personal property would be treated as real property for purposes of apportioning interest income if the personal property's fair market value does not exceed 15% of the combined fair market value. These amendments would be effective for tax years beginning after December 31, 2014.

KPMG observation

Under the proposed provision, the fair market value of personal property covered by a mortgage would be determined in the same manner as the fair market value of real property for the purpose of apportioning interest income under the 75% income test. For that purpose, the fair market value of real property is generally determined as of the date on which the REIT's commitment to acquire the loan becomes binding on the REIT. Thus, the determination whether personal property would be treated as real property for interest income apportionment would ordinarily occur only once.

These provisions were included in the *Update and Streamline REIT Act of 2012* (H.R. 5746) and would simplify a REIT's determination of its compliance with income source and asset holding requirements.

Hedging provisions

Under the discussion draft (section 3642 of the draft legislation), effective for tax years beginning after December 31, 2014, income from counteracting hedges would be similarly excluded for purposes of the income tests.

Specifically, if (1) a REIT enters into qualifying liability hedges or qualifying currency hedges with respect to qualifying property; (2) any portion of the liabilities is extinguished or any portion of the property is disposed of; and (3) in connection with such extinguishment or disposition, the REIT enters into hedging transactions (i.e., counteracting hedges) with respect to the original hedges, any income from the original

and counteracting hedges would not constitute gross income for purposes of the income tests.

Further, a conforming amendment would be made to reference the new identification provision (including a reference to curative regulations dealing with inadvertent failures to identify).

KPMG observation

A REIT may use a counteracting hedge to effect, economically, either a partial or complete termination of an original hedge at potentially reduced costs. Recently, in PLR 201406009, the IRS ruled that (1) pursuant to section 856(c)(5)(G) of the Code, a REIT's gross income from the original hedges would not constitute gross income for purposes of the income tests; and (2) pursuant to section 856(c)(5)(J)(i), a REIT's gross income from the counteracting hedges would not constitute gross income for purposes of the income tests.

In the letter ruling, the REIT entered into hedging transactions in the normal course of

its business to manage risk of interest rate changes or fluctuations with respect to secured and unsecured borrowings made or to be made to acquire or carry real estate assets on an aggregate basis. Because of the fluctuations of the principal amount outstanding on its floating rate debt, the REIT needed to adjust the amount of its interest rate hedge from time to time. To reduce the notional amount of an interest rate hedge to more closely match REIT's current or anticipated indebtedness, the REIT proposed entering into counteracting, or reversing, hedge transactions rather than terminating all or a portion of an existing original hedge and entering into a new hedge.

The IRS reasoned "the counteracting hedging transactions entered into by Company also qualify as hedging transactions under section 1.1221-2(d)(3) of the regulations because, as represented by Company, they are entered into to offset all or part of the risk management effected by the original hedging transactions."

The discussion draft provision would allow a REIT to manage its interest rate and currency risks more effectively without the need to secure letter rulings.

These provisions would amend Code sections 856(c)(5) and 1221(b).

Modify REIT E&P to avoid double taxation

The discussion draft (section 3643 of the draft legislation) would make technical modifications to Code sections 857(d) and 562(e)—provisions of the Code primarily intended to provide that the REIT has sufficient E&P to support its required dividend distribution.

Because E&P and taxable income may be computed differently, REITs can be deemed under these Code sections to have higher E&P than their actual earnings. In some situations, this results in taxable dividends to shareholders that exceed actual historic earnings.

The technical modifications in the discussion draft would be intended to prevent this result. The provision would apply to tax years beginning after December 31, 2014.

Taxable REIT subsidiary (TRS) provisions

Limitation on TRSs. The discussion draft (section 3644 of the draft legislation) would limit the value of taxable REIT subsidiary securities that a REIT may own to no more than 20% of the REIT's total assets. This provision would apply for tax years beginning after 2016.

KPMG observation

When originally enacted, the taxable subsidiary limitation was 20% of a REIT's assets. This limit was increased to 25% in 2008. The draft proposal would reduce the limit to its pre-2008 level.

Certain services by TRSs. Under the discussion draft (section 3645 of the draft legislation), a REIT would be permitted to use its TRS (in addition to an independent contractor) with respect to the marketing and development expenditures under the prohibited transaction safe harbor (Code section 857(b)(6)(C)(v)) and foreclosure property provision (Code section 856(e)(4)(C)).

Furthermore, a new category of transactions between a REIT and its TRS would be subject to the 100% excise tax: redetermined TRS service income, which means the TRS's gross income attributable to services provided to, or on behalf of, its REIT (less deductions properly allocable thereto) to the extent the amount of such income (less such deductions) would be increased on distribution, apportionment, or allocation under section 482.

These provisions would be effective for tax years beginning after December 31, 2014.

KPMG observation

For purposes of the prohibited transaction safe harbor, if a REIT has more than seven sales of property during a year, the statute currently requires the use of independent contractors for substantially all of the marketing and development expenditures with respect to the property. Similarly, an independent contractor is required if a foreclosure property is used by a REIT in a trade or business after 90 days of the acquisition. If enacted, a REIT with internal expertise would not be forced to outsource these functions and incur additional costs.

Study relating to TRSs. Under the discussion draft (section 3646 of the draft legislation), the Treasury Department would be required to conduct a biannual study, and submit a report to the Ways and Means Committee and Senate Finance Committee, regarding the number of TRSs in existence, the aggregate amount of taxes paid by TRSs, and the amount by which transactions between TRSs and their parent REITs reduce the taxable income of the TRSs. The provision would be effective on the date of enactment.

C corporation conversion or asset transfer to a RIC or a REIT

The discussion draft (section 3647 of the draft legislation) would require any C corporation that converts to a RIC or REIT to recognize gain or loss as if all its assets were sold immediately before the close of the last tax year before the RIC or REIT election was effective.

A similar rule would apply to any transfer of assets from a C corporation to a RIC or a REIT in a carryover basis transaction (in whole or in part), and gain or loss would be recognized on the day before the transfer. The provision would not apply if it would result in an overall net loss. The provision would apply to elections and transfers on or after February 26, 2014.

KPMG observation

Under the existing built-in gain rules of Reg. section 1.337(d)-7, entities that convert to RICs or REITs—or transfer property to RICs or REITs in certain tax-deferred transfers—generally are subject to the built-in gain rules applicable to S corporations in section 1374, unless the converting entity or transferor elects deemed sale treatment. The built-in gain rules generally permit the entity to not pay corporate-level tax on appreciated assets, so long as the assets are not sold for a specified period of years (generally, 10 years, but this period would be shortened under the draft proposal).

The proposal thus would eliminate the option of applying the built-in gain rules and would require immediate and full gain recognition on appreciated assets.

Unlike the deemed sale rules in Reg. section 1.337(d)-7, however, the proposal does not assume that the deemed sale occurs with an unrelated party. Thus, various provisions of the Code that apply to related-party transactions (e.g., section 1239, character of gain on sale of depreciable asset to related party) could be applicable to a conversion that is subject to this proposed rule.

Note also that Reg. section 1.337(d)-7 (the built-in gain regulations) provides special rules for situations when a tax-exempt organization is classified as a C corporation, or when a partnership with one or more corporate partners transfers assets to a RIC or a REIT. The discussion draft does not address these situations.

Interests in RICs and REITs under FIRPTA rules

The discussion draft (section 3648 of the draft legislation) would prevent a sale of shares in a RIC or a REIT from relying on an exception to the application of FIRPTA, which is otherwise available to corporations that have disposed of all their real estate assets in taxable transactions. The provision would be effective for dispositions after 2014.

KPMG observation

Generally, shares in a U.S. corporation are treated as U.S. real property interests under FIRPTA if the corporation held predominantly U.S. real property assets at any time during the five years preceding a disposition of the shares. A corporation is not subject to this rule if it currently holds no U.S. real property and all the U.S. real property that it held during the preceding five years was disposed of in fully taxable transactions. The proposal would make this exception unavailable to RICs and REITs.

Historically, some REITs (and RICs) relied on this exception when they sold all their assets and liquidated pursuant to section 331 (i.e., taxable liquidation), while claiming a dividends paid deduction for the liquidating distribution under section 562(b). In Notice 2007-55, the IRS indicated that it would issue regulations stating that a liquidating distribution in these circumstances could not be treated as sale/exchange proceeds under section 331, but must be treated as a capital gain distribution for purposes of FIRPTA.

To the extent the principles in Notice 2007-55 are considered already applicable to transactions, the changes proposed in the discussion draft would not materially alter the landscape for RICs and REITs. In addition, shares in a RIC are only treated as U.S. real property interests with respect to a more than 5% holder in a class of RIC shares under section 897(c)(3) and Reg. section 1.897-9T(d)(2). Since no change is proposed to this exception, this is another reason that this draft provision is unlikely to materially alter the landscape for RICs.

Dividends from RICs and REITs paid through foreign corporation

The discussion draft (section 3649 of the draft legislation) provides that RICs and REITs would not be treated as domestic corporations for purposes of Code section 245(a)(5)(B) (relating to the dividend received deduction for a domestic corporation's dividends from a 10%-owned foreign corporation having U.S.-source income or dividends).

KPMG observation

Corporate shareholders in REITs are not permitted a dividends received deduction (DRD) for distributions from REITs because REITs are entitled to a dividends paid deduction for the same amounts. See Code section 857(c)(1).

Corporate shareholders in RICs may be entitled to a DRD, contingent on the RIC identifying what portion of the dividend is eligible under the rules of Code section 854. Nevertheless, neither section 857(c)(1) nor section 854 applies to prohibit or limit a DRD under section 245 when a RIC or REIT pays a dividend to a foreign corporation that is eventually repatriated to its U.S. corporate shareholder. The proposed change to section 245 would prevent a DRD in this situation.

For more information, contact a tax professional with the REITS and RICs group of KPMG's Washington National Tax:

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Excise taxes

The discussion draft would repeal, modify, or clarify certain existing excise taxes and would impose an excise tax on "systemically important financial institutions."

In brief, the discussion draft includes proposals that would:

- Repeal the medical device excise tax (as imposed under current law) on a manufacturer or importer's sale of its taxable medical devices at a rate of 2.3% of the sales price of such device, effective for sales after the date of enactment
- Modify the oil spill liability trust fund excise tax (imposed under current law and expiring after 2017) on crude oil received at a U.S. refinery and on imported petroleum products, by extending the application of the tax to any bitumen or bituminous mixture, any oil derived from a bitumen or bituminous mixture, shale oil, and any oil derived from kerogen-bearing sources, effective 60 days after date of enactment and extending the tax at a rate of nine cents per barrel for 2018 through 2023
- Modify the inland waterways trust fund excise tax (imposed under current law) on fuel used in powering commercial cargo vessels on inland or intra-coastal waterways, by increasing the tax rate from 20 cents per gallon to 26 cents per gallon, effective for fuel used after 2014
- Clarify the orphan drug exception to the annual fee on branded prescription drugs (imposed under current law) on certain entities engaged in manufacturing or importing branded prescription drugs for sales to specified government programs, by expanding eligibility for the orphan drug exemption, effective for calendar years after 2013. The orphan drug exemption would include any drug or biological product that is approved or licensed by the Food and Drug Administration for marketing solely for one or more rare diseases or conditions—regardless of whether the section 45C credit was ever allowed. A disease or condition would be considered "rare" if it either affects fewer than 200,000 U.S. persons or there is no reasonable expectation that the cost of developing and making the drug available will be recoverable from sales.
- Impose a new excise tax on systemically important financial institutions.

For more information, contact a tax professional with the Excise Tax group of KPMG's Washington National Tax:

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Energy and natural resources

The discussion draft would revise the tax treatment of alternative energy, oil and gas, mining, and timber.

Alternative energy

Production tax credit. A provision of the discussion draft (section 3206 of the draft legislation) would phase down and repeal the Code section 45 production tax credit (PTC).

Under current law, the PTC is available for a 10-year credit period to qualified facilities on which construction began prior to January 1, 2014. The PTC base credit amount is 1.5 cents per kilowatt-hour, adjusted annually for inflation. For 2013, the inflation-adjusted credit amount for wind facilities is 2.3 cents per kilowatt-hour.

The proposal would repeal the inflation adjustment factor for electricity produced and sold after 2014 so that a taxpayer's credit amount would revert to 1.5 cents per kilowatt-hour for the remaining portion of the 10-year credit period. The proposal would also repeal the PTC entirely for electricity produced and sold after 2024.

The proposal would also add the requirement that construction shall not be treated as beginning on a qualified facility before any date unless there is a continuous program of construction that begins before such date and ends on the date the facility is placed in service

KPMG observation

The repeal of the inflation adjustment factor would affect existing investments in renewable energy projects. For example, an investor who invested in a wind project placed in service in 2013 invested in the project on the assumption that the project would earn tax credits at a rate of 2.3 cents per kilowatt-hour with an increase in credit rate every year until 2023. The proposed repeal of the inflation adjustment factor would significantly affect the economics of this investment, so that the investor may never reach its target return on investment.

In addition, current law allows taxpayers to elect to claim the 30% investment tax credit under section 48 instead of the PTC for qualified facilities on which construction began prior to 2014. Proposed repeal of the inflation adjustment factor could likely cause taxpayers to opt for the investment tax credit instead of the PTC for projects that have not yet been placed in service.

The continuous program of construction requirement is included as part of the existing IRS guidance on the "begin construction" rules, though the IRS guidance states that the requirement is deemed satisfied if the facility is placed in service by 2016. It is unclear

how the proposal would operate in light of the current IRS guidance and it is also unclear if or how the continuous construction requirement in the proposal is intended to apply to facilities that "begin construction" under the 5% safe harbor provided in the IRS guidance.

Investment tax credit. A provision of the discussion draft (section 3224 of the draft legislation) would repeal the Code section 48 investment tax credit (ITC) for all property placed in service after 2016.

Under current law, the ITC is available for up to 30% of the cost of new energy property, including solar equipment, placed in service by December 31, 2016. For solar, a 10% ITC is available for property placed in service after 2016.

Residential energy efficiency property credit. A provision of the discussion draft (section 1304 of the draft legislation) would repeal the credit under Code section 25D for the purchase of new residential energy efficiency property, such as rooftop solar equipment, placed in service prior to 2017. The proposed repeal would be effective for property placed in service after 2014.

Plug-in vehicle credit. A provision of the discussion draft (section 1308 of the draft legislation) would repeal the Code section 30D credit for the purchase of new plug-in electric drive motor vehicles.

For vehicles purchased after December 31, 2009, section 30D currently provides a $7,500 maximum credit with a 200,000 vehicle per manufacturer limitation. The proposed repeal would be effective for vehicles acquired after 2014.

Amortization of pollution control facilities. A provision of the discussion draft (section 3105 of the draft legislation) would repeal the election under Code section 169 to amortize certified pollution control facilities over a 60-month period (or 84-month period, depending on type of facility).

Such facilities would be subject to the general depreciation rules, generally using the class life of the underlying property (e.g., 40-year life of the building to which the facility is attached). The repeal would be effective for facilities placed in service after 2014.

Credit for carbon dioxide sequestration. The section 45Q secured carbon dioxide credit for 2013 is $21.25 per metric ton, and the tertiary injectant carbon dioxide credit amount for 2013 is $10.63 per metric ton. Under current law, the section 45Q credit is available until the tax year in which the IRS, in consultation with the EPA, certifies that 75,000,000 metric tons of qualified carbon dioxide was accounted for under section 45Q. As of May 14, 2013, the aggregate amount of qualified carbon dioxide taken into account for purposes of section 45Q is 20,858,926 metric tons.

A provision of the discussion draft (section 3221 of the draft legislation) would repeal the Code section 45Q credit, effective for credits determined for tax years beginning after 2014.

KPMG observation

Many within the solar industry have hoped that the IRS would determine, through a private letter ruling or otherwise, that solar energy property could be treated as real property for REIT purposes, thus making REITs available as an investment vehicle for solar. This proposal would presumably eliminate the possibility that solar property could be a "good REIT asset."

Reduce tax rate for income of nuclear decommissioning reserve funds. A provision of the discussion draft (section 3309 of the draft legislation) would repeal the 20% tax rate on the income of nuclear decommissioning reserve funds and instead apply the generally applicable corporate tax rate.

MACRS. The discussion draft would repeal MACRS recovery periods and rules substantially similar to the ADS rules would apply. A more detailed analysis of proposed MACRS changes is available in the accounting section.

KPMG observation

Under current law, wind and solar energy property are depreciated using five-year MACRS, using the double declining balance recovery method, which provides for the greatest depreciation allowance in the first full year of use and declines over time. Under the proposal, these assets would be depreciated over a 12-year period and on a straight-line basis. In addition, coal and natural gas power generation plants—currently depreciated using 20-year MACRS—would be depreciated over 28 years if MACRS were repealed, and nuclear power plants would go from 15-year MACRS to 20-year straight-line.

The rapid cost recovery afforded by five-year MACRS has played a key role in the development of renewable energy projects. The elimination of MACRS would lower potential investment returns and hamper the development of renewable energy projects.

Short-lived property not treated as real property for REIT purposes. The discussion draft provides that the term "real property" for purposes of the REIT income tests would not include tangible personal property with a class life of less than 27.5 years. The provision would be effective for tax years beginning after 2016.

Other repealed provisions. The discussion draft would repeal several additional alternative energy provisions:

- Section 25C credit for nonbusiness energy property (discussion draft section 1303)
- Section 30 credit for qualified electric vehicles (section 1305)
- Section 30B credit for alternative motor vehicles (section 1306)
- Section 30C credit alternative fuel vehicle refueling property (section 1307)
- Section 179D deduction for energy efficient commercial buildings (section 3113)
- Section 40 credit for alcohols, etc., used as fuel and the second generation biofuel producer credit, and Code sections 6426 (related to excise tax credits for mixtures of alcohol, biodiesel, and alternative fuel, and for alternative fuels) and 6427(e) relating to excise tax payments for mixtures of alcohol, biodiesel, and alternative fuel, and for alternative fuels) (section 3201)
- Section 40A credit for biodiesel and renewable diesel used as a fuel (section 3202)
- Section 45H credit for production of low sulfur diesel fuel (section 3213)
- Section 45J credit for production from advanced nuclear power facilities (section 3215)
- Section 45K credit for production of fuel from a nonconventional source (section 3216)
- Section 45L credit for new energy efficient homes (section 3217)
- Section 45M credit for energy efficient appliances (section 3218)
- Section 45O credit for agricultural chemical security (section 3220)
- Section 48A credit for qualifying advanced coal projects (section 3225)
- Section 48B credit for qualifying gasification projects (section 3226)
- Section 48C credit for advance energy projects (section 3227)

Most of these provisions have already expired, or their repeal would have no or very little revenue effect.

Oil & Gas

Deductions for intangible drilling and development costs, certain refinery costs. Under the discussion draft, the election to deduct intangible drilling and development costs (IDC) under Code section 263(c) would be unchanged, but IDC would no longer be a tax preference item as the alternative minimum tax would be repealed. Further, taxpayers would no longer have the option to amortize IDC over a 60-month period

under IRC section 59(e). See the "Accounting" section for more details on the repeal of the amortization option for certain expenditures.

Under section 3112 of the draft legislation, the now expired Code section 179C election to deduct certain refinery costs would not be renewed.

Deduction for income attributable to domestic production. Under section 3122 of the draft legislation, the Code section 199 deduction for income attributable to domestic production would be phased out.

Percentage depletion. Under a provision of the discussion draft (section 3130 of the draft legislation), percentage depletion for oil and gas (which has been in the tax law since 1926) would be repealed by eliminating Code section 613A.

KPMG observation

If percentage depletion is repealed, oil and gas producers would have to rely on cost depletion. Unfortunately, no simplified method for computing cost depletion would be provided. This could cause tax compliance issues for many independent producers and royalty owners who often do not have access to the reserve reports needed to properly compute cost depletion. Percentage depletion for integrated oil and gas producers had generally been eliminated for tax years beginning after 1974.

Passive activity rules. Under section 3131 of the draft legislation, the oil and gas exception of Code section 469(c)(3) to the passive activity rules for working interests held directly or through an entity which does not limit the liability of the taxpayer with respect to such interest would be repealed.

Like-kind exchange rules. Section 3133 of the discussion draft would repeal the like-kind exchange rules under Code section 1031.

KPMG observation

Repeal of the like-kind exchange rules could have a substantial negative impact on some natural resource conservation measures, which are often required by local law. Natural resource property is defined by section 614. Specifically, section 614(b)(3) treats properties participating in a unitization or pooling agreement as a single property. Unitizations and poolings are conservation techniques that prevent producers who own tracts of land over a larger pool of minerals from rushing to produce reserves (law of capture) from that pool of minerals and often reducing the total recovery of reserves.

For federal income tax purposes the term "unitization or pooling agreement" means an agreement under which two or more persons owning operating mineral interests agree to have the interests operated on a unified basis, and the owners also agree to share in production on a stipulated percentage or fractional basis regardless of which interest or interests the oil or gas is produced from. In addition, when one person owns all the operating mineral interests in several leases, an agreement among its several royalty owners to determine the royalties payable to each on a stipulated percentage basis (regardless of which lease(s) oil or gas is produced from) is also considered to be a unitization or pooling agreement. No formal cross-conveyance of properties is necessary.

Rev. Rul. 68-186, 1968-1 C.B. 354 noted that:

> The position that a unitization effects an exchange was confirmed by the amendment to section 614 of the Internal Revenue Code of 1954 made by the Revenue Act of 1964. … The exchange of working interests qualifies, as does the exchange of equipment, under section 1031 of the Code as property held for productive use in a trade or business or for investment which is exchanged solely for property of a like kind to be held for use in a trade or business or for investment.

On some federal offshore properties, the producers cannot enter a unit without first drilling a producing well. This causes a series of unit enlargements (e.g., up to 12 enlargements of the same unit), each of which is treated as a section 1031 exchange.

Treating unitizations and poolings (including communalizations formed pursuant to 30 U.S.C. section 226(m); 43 C.F.R. section 3105.2-2) as taxable events would run counter to their conservation nature, causing unwarranted substantial tax bills.

Credits for enhanced oil recovery and producing oil and gas from marginal wells. A provision of the discussion draft (section 3205 of the draft legislation) would repeal the Code section 43 enhanced oil recovery credit (which has been price phased out since 2006).

Another provision (section 3214 of the draft legislation) would repeal the Code section 45I credit for producing oil and gas from marginal wells (which has been price phased out since 2006).

LIFO repeal. A provision of the discussion draft (section 3310 of the draft legislation) would repeal the Code section 472 LIFO inventory method of accounting.

Recurring item exception for spudding of oil or gas wells. A provision (section 3317 of the draft legislation) would repeal the Code section 461(i)(2) recurring-item exception to economic performance for spudding oil and gas wells.

PTPs. Under a provision of the discussion draft (section 3620 of the draft legislation), the Code section 7704 current qualified income exceptions to treating PTPs as corporations would be repealed—except for income derived from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil or products thereof), or marketing of any mineral or natural resource (including geothermal energy and excluding fertilizer and timber) or industrial-source carbon dioxide and any gain from the sale or disposition of a capital asset (or property described in section 1231(b)) held for the production of the types of income described above. See Limitations on types of PTPs.

Mining

Deductions for mine exploration and development and mine safety equipment. Under the discussion draft, the election to deduct mine exploration and development costs under sections 617 and 616 would be unchanged, but mine exploration and development costs would no longer be adjustment items under section 56(e)(2) because the alternative minimum tax would be repealed. Further, taxpayers would no longer have the option to amortize mine exploration and development costs over a 10-year period under IRC section 59(e).

Under a provision of the discussion draft (section 3114 of the draft legislation), the now expired Code section 179E election to expense advanced mine safety equipment would be repealed.

Deduction for income attributable to domestic production. The section 199 deduction for income attributable to domestic production would be phased out.

Percentage depletion. Under a provision of the discussion draft (section 3130 of the draft legislation), percentage depletion (which has been in the tax law since 1926) would be repealed by eliminating Code section 613.

KPMG observation

Unfortunately, as with oil and gas, no simplified method for computing cost depletion would be provided for mining. This could result in tax compliance issues for many small producers and royalty owners who often do not have access to the reserve reports needed to properly compute cost depletion.

Gain or loss on coal or domestic iron ore. A provision of the discussion draft (section 3132 of the draft legislation) would repeal Code section 631(c) providing capital gains treatment from certain disposals with a retained economic interest of coal or domestic iron ore.

Like-kind exchanges. The discussion draft proposes that certain mineral (e.g., carbon dioxide) conservation measures—which generally follow the oil and gas rules and are often required by local law, such as unitizations and poolings—would become taxable events.

Mine rescue team training credit. A provision of the discussion draft would repeal the now expired Code section 45N mine rescue team training credit.

PTPs. A provision of the discussion draft (section 3620 of the draft legislation) would repeal Code section 7704's current qualified income exceptions for treating publicly traded partnerships as corporations—except for income derived from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil or products thereof), or the marketing of any mineral or natural resource (including geothermal energy and excluding fertilizer and timber) or industrial source carbon dioxide and any gain from the sale or disposition of a capital asset (or property described in section 1231(b)) held for the production of the types of income described above.

Timber

Reforestation expenditures. Under a provision of the discussion draft (section 3118 of the draft legislation), the election under Code section 194 would be modified to provide for a seven-year amortization period (with a half-year convention) of reforestation expenditures and limit the qualifying timber property to U.S. property that:

- Contains evergreen trees in commercial quantities that are reasonably expected to be cut down after they are more than six years old, and
- Is held for the planting, cultivating, caring for and cutting of such trees for ornamental purposes—i.e., limited to U.S. Christmas tree farms

The provision would be effective for expenditures paid or incurred in tax years beginning after 2014.

Gain or loss on sale of timber. Under a provision of the discussion draft (section 3132 of the draft legislation), Code section 631(a) and (b) would be repealed, thereby eliminating elective capital gain treatment upon the cutting of timber or the sale of timber or the disposal of timber with a retained economic interest. The provision generally would be effective for tax years beginning after 2014.

Capitalization of timber and certain trees. Under a provision of the discussion draft (section 3312 of the draft legislation), the Code section 263A(c)(5) exception to the uniform capitalization for certain trees would be repealed.

PTPs. A provision of the discussion draft would repeal the section 7704 current qualified income exceptions for treating PTPs as corporations—except for income derived from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil or products thereof), or marketing of any mineral or natural resource (including geothermal energy and excluding fertilizer and timber) or industrial source carbon dioxide and any gain from the sale or disposition of a capital asset (or property described in section 1231(b)) held for the production of the types of income described above.

Timber REITs. Section 856(c) would be amended to exclude timber from qualifying REIT assets.

For more information about the alternative energy provisions, contact a tax professional with KPMG's Washington National Tax:

John Gimigliano (202) 533-4022

Katherine Breaks (202) 533-4878

Hannah Hawkins (202) 533-4225

For more information about the oil and gas, mining, and timber provisions, contact a tax professional with KPMG's Washington National Tax (in Houston):

Robert Swiech (713) 319-3257

Employment benefit and tax provisions

The discussion draft proposes changes that would affect the tax treatment of employee benefits, employment tax, executive compensation, worker classification, and retirement benefits.

Employee benefits

- *Employee-achievement awards.* The discussion draft would repeal the exclusion for employee-achievement awards, so that such awards would constitute taxable compensation to the recipient. The proposal also would repeal the restrictions on employer deductions for such awards.
- *Housing*. Under the proposal, the exclusion for housing provided for the convenience of the employer and for employees of educational institutions would be limited to $50,000 ($25,000 for a married individual filing a separate return). The exclusion also would be limited to one residence.
- *Transportation*. The proposal would repeal the exclusion from income for air transportation provided as a no-additional-cost service to the parent of an employee. For the qualified transportation fringe benefit, the proposal would set the qualified transportation fringe excludable qualified parking amount at $250 per month, and the excludable transit pass amount at $130 per month. These amounts would no longer be adjusted for inflation. The proposal would repeal the qualified bicycle commuting reimbursement. The proposal would be effective for tax years beginning after 2014.
- *Unrealized appreciation in employer securities.* Under the proposal, the exclusion for net unrealized appreciation in distributed employer securities would be repealed. The distributee generally would have income in the amount of the value of the distributed securities. The proposal would be effective for distributions after 2014.

Employment tax

The discussion draft proposal would expand the application of employment taxes by eliminating various exemptions.

- Under the proposal, the deduction with respect to net earnings from self-employment would be modified to make SECA taxes economically equivalent to FICA taxes.
- The proposal would repeal the exemption from FICA taxes for certain foreign workers so income would be subject to FICA while in the United States on the same basis as applies to other employees in the United States.
- The proposal would repeal the exemption from FICA taxes for certain students for services performed after 2014. The FICA exception for students would be limited to student earnings that are less than the amount needed to receive a quarter of Social Security covers for the year ($1,200 for 2014).

- Under the proposal, the IRS guidance exempting certain supplemental unemployment benefit payments from payroll tax withholding would be overridden. The general tax treatment of severance benefit payments would be clarified, so that all such payments would be subject to income and payroll taxes (i.e., FICA, FUTA, and RRTA).

Individual retirement accounts (IRAs)

No income limits on contributions to Roth IRAs and no new contributions to traditional IRAs. Under the discussion draft proposals, the income eligibility limits for contributing to Roth IRAs would be eliminated and new contributions to traditional IRAs and non-deductible traditional IRAs would be prohibited. The inflation adjustment of the annual limit on Roth IRA contributions also would be suspended until tax year 2024, at which time inflation indexing would recommence based off the frozen level. The proposals would be effective for tax years beginning after 2014.

Repeal of special rule permitting recharacterization of Roth IRA contributions as traditional IRA contributions. Under the discussion draft proposal, the rule allowing re-characterization of Roth IRA contributions or conversions would be repealed. Note that under other proposals of the discussion draft, no new contributions to traditional IRAs would be permitted. The proposal would be effective for tax years beginning after 2014.

Repeal of early-distribution penalty exception for first homes. Under the proposal, the exception to the additional 10% tax for early distributions used to pay for first-time homebuyer expenses would be repealed. The proposal would be effective for distributions after 2014.

Prohibition of employer creation of new SEPs or SIMPLE 401(k) plans. Employers would be permitted to continue making contributions to existing SEPs and SIMPLE 401(k) plans. SIMPLE IRAs would continue to be available. The SEP proposal would be effective for tax years beginning after 2014, and the SIMPLE 401(k) proposal would be effective for plan years beginning after 2014.

Other qualified retirement plans

Rules related to designated Roth contributions. Under the discussion draft proposals, employees would generally be able to contribute up to half the maximum annual elective deferral amount (including catch-up contributions for employees at least 50 years old, if applicable) into a traditional account.

For 2014, the maximum annual elective deferral amount would be $17,500, and the maximum catch-up amount is $5,500 (for a potential total of $23,000 for such employees). Any contributions in excess of half of these limits—$8,750 and $11,500, respectively—would go to a Roth account. Employees could contribute up to the entire annual elective deferral amount into a Roth account if they wish. Plans would generally

be required to offer Roth accounts. Employer contributions would continue to be made to traditional accounts.

The proposal would not apply to employers with 100 or fewer employees. In addition, employers may choose to have Roth accounts in a SIMPLE IRA, and if an employer with a SIMPLE IRA elects to limit traditional employee contributions to half the annual contribution limits, the employee contribution limits to the SIMPLE IRA would be increased to the contribution limits for a 401(k) plan. For purposes of this proposal, 403(b) plans and 457(b) plans would be treated like 401(k) plans. The proposal would generally be effective for plan years and tax years beginning after 2014. The SIMPLE IRA portion of the proposal would be effective for tax years and calendar years beginning after 2014.

Modifications of required distribution rules for pension plans. Under the discussion draft, if an employee becomes a 5% owner after age 70½ but before retiring, the required beginning date for required minimum distributions (RMDs) would be April 1 of the following year. With respect to IRAs and employer-sponsored retirement plans that exist when the IRA owner or employee dies, distributions would be required within five years (regardless of whether the IRA owner or employee dies before or after RMDs have begun). An exception would apply if the beneficiary is a spouse, disabled, chronically ill, not more than 10 years younger than the deceased, or is a child; distributions would be permitted to begin within one year of death and be spread over the life expectancy of the beneficiary. However, if that beneficiary dies or a child beneficiary turns 21, the general five-year distribution rule would then apply.

The proposal regarding RMDs after the death of an IRA owner or employee generally would be effective for distributions with respect to IRA owners or employees who die after 2014. The proposals would not apply to certain qualified annuities that are binding annuity contracts in effect on the date of enactment and at all times thereafter. The proposal changing RMDs for 5% owners generally would become effective for employees becoming 5% owners with respect to plan years ending in calendar years beginning before, on, or after the date of enactment—except that the proposal would not result in a required beginning date earlier than April 1, 2015.

Qualified plans

Minimum age for allowable in-service distributions. Under the proposal, all defined-benefit plans as well as state and local government defined-contribution plans would be permitted to make in-service distributions beginning at age 59½. The proposal would be effective for distributions made after 2014.

Guidance on hardship distributions. Under the proposal, the IRS would be required within one year of the date of enactment to change its guidance to allow employees

taking hardship distributions to continue making contributions to the plan. The proposal would be effective for plan years beginning after 2014.

Outstanding plan loans. Under the proposal, employees whose plan terminates or who separate from employment while they have plan loans outstanding would have until the due date for filing their tax return for that year to contribute the loan balance to an IRA in order to avoid the loan being taxed as a distribution. The proposal would apply to tax years beginning after 2014.

Unification of contribution limits. Under the proposal, all defined-contribution plans (including 403(b) plans and governmental 457(b) plans) would be subject to the annual contribution limits currently applicable to 401(k) plans and would not have additional limits for different classes of employees at certain types of employers. The proposal would apply to plan years and tax years beginning after 2014.

Unification of early-distribution penalties. Early distributions from employer-sponsored retirement plans and IRAs are generally subject to an additional tax of 10%. This additional tax does not apply to early distributions from 457 plans sponsored by state and local governments. Under the proposal, participants in governmental 457 plans would be subject to the 10% additional tax on early distributions. The proposal would be effective for withdrawals after February 26, 2014.

Freeze on inflation adjustments. Under the proposals, the inflation adjustments for the maximum benefit under a defined-benefit plan, the maximum combined contribution by an employer and employee to a defined-contribution plan, the maximum elective deferrals with respect to each type of SEP, SIMPLE IRA, and defined-contribution (i.e., 401(k), 403(b), and 457(b)) plans, and catch-up contributions would be suspended until 2024, at which time inflation indexing would recommence based off the frozen level.

Executive compensation

Nonqualified deferred compensation

Under the proposal, an employee would be taxed on compensation as soon as there is no substantial risk of forfeiture with regard to that compensation (i.e., receipt of the compensation is not subject to future performance of substantial services). The proposal would be effective for amounts attributable to services performed after 2014. The current-law rules would continue to apply to existing non-qualified deferred compensation arrangements until the last tax year beginning before 2023, when such arrangements would become subject to the proposal.

Modify limitation on excessive employee remuneration

Under the proposal, the exceptions to the $1 million deduction limitation for commissions and performance-based compensation would be repealed. The proposal

also would revise the definition of "covered employee" to include the CEO, the chief financial officer, and the three other highest-paid employees, realigning the definition with current SEC disclosure rules.

Under the modified definition, once an employee qualifies as a covered person, the deduction limitation would apply for federal tax purposes to that person as long as the corporation pays remuneration to such person (or to any beneficiaries). The proposal would be effective for tax years beginning after 2014.

Excise tax on excess tax-exempt organization executive compensation

Under the proposal, a tax-exempt organization would be subject to a 25% excise tax on compensation in excess of $1 million paid to any of its five highest paid employees for the tax year. The excise tax would apply to all remuneration paid to a covered person for services, including cash and the cash value of all remuneration (including benefits) paid in a medium other than cash, except for payments to a tax-qualified retirement plan, and amounts that are excludable from the executive's gross income.

Once an employee qualifies as a covered person, the excise tax would apply to compensation in excess of $1 million paid to that person as long as the organization pays him remuneration. The excise tax also would apply to excess parachute payments paid by the organization to such individuals. Under the proposal, an excess parachute payment generally would be a payment contingent on the employee's separation from employment with an aggregate present value of three times the employee's base compensation or more. The proposal would be effective for tax years beginning after 2014.

Other employment provisions

Deny deduction for ISOs as research expenditure. Under the proposal, the rules with respect to ISO plans and ESPPs would be clarified to deny a deduction under any provision of the Code for a transfer of stock to an individual under such plans. The proposal would be effective for stock transferred after February 26, 2014.

Eliminate deductions for entertainment expenses. Under the proposal, no deduction would be allowed for entertainment, amusement or recreation activities, facilities, or membership dues relating to such activities or other social purposes. In addition, no deduction would be allowed for transportation fringe benefits or for amenities provided to an employee that are primarily personal in nature and that involve property or services not directly related to the employer's trade or business, except to the extent that such benefits are treated as taxable compensation to an employee (or includible in gross income of a recipient who is not an employee).

The 50% limitation under current law also would apply only to expenses for food or beverages and to qualifying business meals under the provision, with no deduction

allowed for other entertainment expenses. Furthermore, no deduction would be allowed for reimbursed entertainment expenses paid as part of a reimbursement arrangement that involves a tax-indifferent party such as a foreign person or an entity exempt from tax. The proposal would be effective for amounts paid or incurred after 2014.

Repeal pension credit. Under the proposal, the credit for small employer pension plan start-up costs would be repealed. The proposal would be effective for costs paid or incurred after 2014 with respect to qualified employer plans first effective after such date.

Repeal employer-provided child care credit. Under the proposal, the credit for employer-provided child care would be repealed. The provision would be effective for tax years beginning after 2014.

Worker classification. Under the proposal, workers qualifying for a safe harbor would not be treated as employees, and service recipients would not be treated as employers for any federal tax purpose. The safe harbor also would apply to three-party arrangements in which a payor other than the service recipient pays the worker. To qualify for the safe harbor, the worker would have to satisfy certain sales or service criteria and the worker and service recipient would be required to have a written agreement meeting specified requirements. In addition, the service recipient would withhold tax on the first $10,000 of payments made to the worker in a year at a rate of 5%. Amounts withheld under the safe harbor would be creditable by the worker against quarterly estimated-tax requirements.

In any situation when the IRS determines that the requirements of the safe harbor were not satisfied, the proposal generally would limit the IRS to reclassification of the worker as an employee and service provider as an employer on a prospective basis. To avoid retroactive reclassification, the worker or service provider would have to have satisfied the written agreement and the reporting and withholding requirements of the safe harbor and to have had a reasonable basis for claiming that the safe harbor applied.

Indian general welfare benefits. Under the discussion draft, proposed IRS guidance applying the general welfare exclusion to Indian tribes and payments received by tribal members, their spouses, and children generally would be codified. The proposals also would require the IRS to establish a Tribal Advisory Committee to advise the IRS on matters relating to taxation of tribal members including training and education for IRS agents dealing with tribal members. Additionally, the proposals would provide the IRS with discretion to waive any interest and penalties under the Code for any tribe or tribal member with regard to the general welfare exclusion. The proposal codifying the IRS guidance concerning the general welfare exclusion would be effective for tax years for which the period of limitations is open as of the date of enactment, and taxpayers would

have one additional year from the date of enactment to file for a refund with respect to any such open tax year.

For more information, contact a tax professional with the Compensation and Benefits group of KPMG's Washington National Tax:

Karen Field (202) 533-4234

Terri Stecher (202) 533-4830

Practice and procedure provisions

Among the discussion draft's proposed changes to practice, procedure, and IRS administration provisions of the Code are measures that would increase the threshold for JCT review of refunds made to C corporations and revise the filing dates of income tax returns by corporations, partnerships, and S corporations.

Increase refund and credit threshold for JCT review of C corporation returns

The threshold for JCT review of refunds or credits with respect to returns for C corporations would be increased to $5 million. The current threshold of $2 million would continue for other taxpayers.

Modify due date for returns of partnerships, S corporations, and C corporations

Under the discussion draft's proposals, the due dates for filing tax returns would be modified as follows:

- Partnerships or S corporations would be required to file by March 15 (or two-and-a-half months after the close of the tax year).
- C corporations would be required to file by April 15 (or three-and-a-half months after the close of the tax year)

In addition, the proposal would also provide C corporations with an automatic six-month extension of the applicable filing date, which would codify extensions currently implemented in the regulations.

The proposal would generally be effective for tax years beginning after 2014. For C corporations with fiscal years ending on June 30, the new filing date would not apply to any year beginning in 2022.

KPMG observation

Many large partnerships and tiered partnerships currently encounter challenges in preparing and filing their returns under the current partnership due date rules. Although moving the due date for the partnership return one month earlier would allow for the receipt of Schedules K-1 prior to the due date of the returns for C corporations (and individuals), it might result in an increased burden for partnerships and S corporations because of the shorter amount of time to gather and prepare the information necessary to prepare their returns.

Partnership audits and adjustment

The existing TEFRA partnership audit procedures and the audit procedures for "electing large partnerships" would be replaced with a single set of rules for auditing partnerships

and their partners at the partnership level. Partnerships with 100 or fewer partners (none of which are passthrough entities) may elect out. Any adjustments for a partnership tax year "reviewed year" would be taken into account by the partnership (not the individual partners) in the year that the audit or judicial review is completed (the 'adjustment year"). The partnership would also have the option of initiating an adjustment for the reviewed year, but with the adjustment taken into account in the adjustment year. It would be effective for partnership tax years ending after 2014, with partnerships permitted to elect to apply the new rules for any partnership year beginning after date of enactment.

Truncated Social Security numbers (SSNs) on Form W-2

Employers would be required to include an "identifying number" on Form W-2 furnished to the employee, rather than the employee's SSN. This would correspond to the current rule for other information returns such as Form 1099, and would allow Treasury and the IRS to exercise regulatory authority to permit a truncated SSN on the Form W-2 to reduce the potential for identity theft.

Clarify six-year statute of limitations in case of overstatement of basis

Under the discussion draft proposal, the six-year statute of limitations for assessment would apply to a return on which the taxpayer claims an adjusted basis for any property that is more than 125% of the correct adjusted basis. The proposal would be effective for returns filed after the date of enactment and for returns filed on or before the date of enactment if the general statute of limitations has not expired.

Free electronic filing

The IRS would be directed to continue working cooperatively with the private-sector technology industry to maintain a program that provides free individual income tax preparation and individual income tax electronic filing services to lower-income and elderly taxpayers similar to the current Free File Program. Treasury and the IRS would be required to issue regulations and guidance for participants and to review and remove any participant that does not meet the program's rules and regulations.

"Pre-populated" returns prohibited

The IRS would be prohibited from instituting any program under which it prepares or otherwise provides taxpayers with proposed or final returns or statements (gathered from third-party information such as Forms W-2 or 1099) intended to be used by the taxpayer to satisfy the taxpayer's reporting obligations.

Form 1040SR for seniors

The IRS would be required to develop a Form 1040SR, similar to Form 1040EZ, for individuals over the age of 65 who receive common types of retirement income.

Currently, individuals over the age of 65 on the last day of the tax year may not use Form 1040EZ.

Penalty changes

Failure-to-file. Under current law, a taxpayer that fails to file a tax return within 60 days of the due date is subject to a minimum penalty equal to the lesser of $135 or 100% of the amount required to be shown on the return. Under the proposed legislation the amount of $400 would be substituted for $135 in determining the amount of minimum penalty.

Failure to file correct information returns and provide payee statements. There is a separate, but parallel, penalty structure for failure to file certain information returns with the IRS and to furnish certain forms and statements to payees. The penalties are based on the duration of the delinquency and the size (gross receipts) of the taxpayer. The proposal would increase the amount and maximum of the penalty for the year:

- If the return or statement is corrected within 30 days of the due date, the penalty would be increased to $50 for each failure, with a maximum of penalty per year of $250,000 for small businesses and $500,000 for all other taxpayers.
- If the return or statement is corrected after 30 days but before August 1, the penalty would be increased to $100 for each failure, with a maximum penalty per year of $500,000 for small businesses and $1.5 million for all other taxpayers.
- If the return or statement is corrected on or after August 1, the penalty would be increased to $250 for each failure, with a maximum penalty per year of $500,000 for small businesses and $3 million for all other taxpayers.
- For taxpayers that intentionally disregard the filing and furnishing requirements, the penalty would be increased to $500 per failure, with no yearly maximum. Note that the current "intentional disregard" penalty provides that the penalty for each failure is the greater of the specific dollar amount or up to 10% of the aggregate amounts required to be reported correctly.

Reform rules related to qualified tax collection contracts

Under the discussion draft proposal, the IRS would be required to use qualified tax collection contracts to collect certain inactive tax receivables.

100% levy on payments to Medicare providers and suppliers

Under the proposal, the Treasury Department would be authorized to increase the levy from 15% to up to 100% of a payment to a Medicare provider to collect unpaid taxes.

Treatment of refundable credits for purposes of certain penalties

Under the discussion draft proposal, the 20% accuracy-related penalty for underpayment of tax would take into account the amount of refundable credits. The

proposal would also amend the penalty for erroneous refund or credit to taxpayers that claim a new credit for employment-related taxes (under a provision contained in section 1103 of the discussion draft).

As proposed, the accuracy-related penalty would be effective for returns filed on or after February 26, 2014, and returns filed on or before such date if the general statute of limitations for assessment has not expired. The penalty for the erroneous refund or credit would be effective for claims filed after February 26, 2014.

IRS employee provisions

Taxpayer rights. Under the discussion draft, the IRS Commissioner's duties would be expanded to include making sure that IRS employees are familiar with and act in accordance with taxpayer rights under the tax laws, including the right to be informed, the right to be assisted, the right to be heard, the right to pay no more than the correct amount of tax, the right of appeal, the right to certainty, the right to privacy, the right to confidentiality, the right to representation, and the right to a fair and just tax system.

Termination of IRS employees for official actions having political purposes. Under the discussion draft, the enumerated acts or omissions that result in mandatory termination of an IRS employee would be expanded to include performing, delaying, or failing to perform (or threatening to perform, delay, or fail to perform) any official action or audit with respect to a taxpayer for the purpose of extracting personal gain or benefit or for political purposes.

Release of information regarding the status of certain investigations. The enumerated circumstances in which taxpayer information may be lawfully disclosed by the Treasury Department would be expanded to include disclosure to certain complainants (or their representatives) of information regarding the status and results of any investigation initiated by their complaint.

Review of IRS examination selection procedures. Under the discussion draft, the Comptroller General would be directed to:

- Conduct an initial review of each IRS operating division to assess the processes used to determine how enforcement cases are selected and worked
- Report to Congress and Treasury the results of the initial review and any recommendations to improve case selection
- Conduct a follow-up review to determine whether the recommendations have been implemented
- Conduct further reviews of each IRS division every four years and direct a report to Congress and Treasury

IRS employees not to use personal email account for official business. IRS employees would be prohibited by statute from using any personal email account to conduct official agency business.

Moratorium on IRS conferences. The IRS would be precluded from holding any conference until Treasury's Inspector General for Tax Administration (TIGTA) submits a report to Congress certifying that the IRS has implemented all of the recommendations included in TIGTA's May 31, 2013 report.

For more information, contact a tax professional with the Practice, Procedure and Administration group of KPMG's Washington National Tax:

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Financial institutions and products

Financial institutions and products

The discussion draft would make various changes to the taxation of financial products and institutions, including the insurance industry.

Deduction for bond premium

A proposed provision (section 1416 of the draft legislation) would permit taxpayers to claim an above-the-line deduction (i.e., regardless of whether a taxpayer itemizes deductions) for amortizable bond premiums. The provision would apply for tax years beginning after 2014.

Interest expense incurred for tax-exempt obligations

A proposed provision (section 3124 of the draft legislation) would substantially modify the "tax arbitrage" rules of Code section 265 as follows:

- Under the draft, C corporations and financial institutions (including dealers in tax-exempt obligations) would be required to calculate the amount of interest disallowed under section 265 based on a single method (the interest-disallowance method), which disallows interest deductions based on the percentage of the taxpayer's assets comprising tax-exempt obligations.
- The special rule under present law for qualified small issuer tax-exempt obligations would also be repealed.

KPMG observation

Together with the proposed repeal of the rules for private activity bonds, these proposals may result in reduced investment in tax-exempt obligations including, in particular, qualified tax-exempt obligations issued by "qualified small issuers" (as currently defined in section 265).

The discussion draft also proposes to change the investment interest limitation rules of section 163(d) by:

- Limiting the amount of interest potentially deductible to the amount of interest in excess of (1) tax-exempt interest received by a taxpayer and (2) net investment income of the taxpayer for the tax year (after reduction for tax-exempt interest received); and
- Clarifying that for purposes of section 163(d), "property held for investment" includes property producing tax-exempt interest (including shares of stock in a regulated investment company (RIC) distributing exempt-interest dividends)

The provision relating to the interest-disallowance method would be effective for tax years ending after and obligations issued after February 26, 2014. The provision relating to the investment-interest deduction would be effective for tax years beginning after 2014.

Corporate acquisition indebtedness

A proposed provision (section 3127 of the draft legislation) would repeal Code section 279, which limits a corporation's interest deduction for certain types of debt issued to acquire the stock or assets of another corporation. The provision would apply to interest paid or incurred on debt incurred after 2014.

Deduction limits for FDIC premiums

A proposed provision (section 3129 of the draft legislation) would limit the amount certain "large" financial institutions could deduct for premiums paid pursuant to an assessment by the FDIC to support the Deposit Insurance Fund. The proposed limitation would apply only if the "total consolidated assets" of a financial institution (determined as of the close of the relevant tax year) are equal to or exceed $10 billion. Special rules would apply for purposes of calculating "total consolidated assets" within a group of related entities.

Under the proposed rule, the limitation would be equal to the ratio (not to exceed 100%) that (1) "total consolidated assets" in excess of $10 billion bears to (2) $40 billion. As a result, for financial institutions with "total consolidated assets" in excess of $50 billion, no deduction for such premiums could be claimed.

The provision would be effective for tax years beginning after 2014.

Small business investment companies

A proposed provision (section 3135 of the draft legislation) would repeal Code section 1044, which permits taxpayers to elect to limit the amount of gain they would otherwise recognize from the sale of publicly traded securities if they use the proceeds to purchase stock or a partnership interest in a specialized small business investment company.

The repeal would be effective for sales occurring after 2014.

Certain property not treated as capital asset

A proposed provision (section 3137 of the draft legislation) would amend Code section 1221(a)(3) to exclude from the definition of "capital asset" any "patent, invention, model or design (whether or not patented), a secret formula or process" that satisfies the other requirements of section 1221(a)(3) (such as when the taxpayer's personal efforts create the property). Thus, any gain or loss arising from the disposition of such properties would be ordinary.

Also, the proposal would repeal the election under section 1221(b)(3) to treat certain musical works as capital assets. These changes would apply to dispositions after December 31, 2014.

Repeal special rule for sale of patents

A proposed provision (section 3138 of the draft legislation) would repeal Code section 1235, which provides that transfers of patents by certain holders are treated as the sale or exchange of a capital asset held for more than one year. This change would apply to dispositions after December 31, 2014.

Derivatives marked to market; ordinary gain or loss

A proposed provision (section 3401 of the draft legislation) would require that derivative financial transactions be marked to market annually with the resulting gain or loss treated as ordinary gain or loss. Such gain or loss would be attributable to a trade or business of the taxpayer for the purposes of determining nonbusiness deductions, which are allowed in computing a net operating loss.

The discussion draft proposal would repeal several current-law provisions related to the timing and character of gain or loss with respect to derivatives, including Code sections 1233, 1234, 1234A, 1256, 1258, and 1259.

The discussion draft proposal would define a derivative to include any contract the value of which, or any payment or other transfer with respect to which, is (directly or indirectly) determined by reference to:

- Any share of stock
- Any partnership or beneficial ownership interest in a partnership or trust

- Any evidence of indebtedness
- Any real property unless otherwise excluded
- Any actively traded commodity
- Any currency
- Any rate, price, amount, index, formula, or algorithm
- Any other item prescribed by the Treasury Secretary, or
- Any combination of the above items

The discussion draft lists options, forward contracts, futures contracts, short positions, swaps, and similar contracts as potential derivatives. American depository receipts and similar instruments would be treated as shares of stock in foreign corporations and not as derivatives.

If a taxpayer has a straddle of a derivative and a non-derivative position, the non-derivative position would be subject to the mark-to-market character and timing rule except for any built-in gain or loss at the time the off-setting derivative was entered into.

On establishing the straddle, the discussion draft proposal would require a taxpayer to recognize built-in gain under the character and net-operating-loss rules that would otherwise apply. The discussion draft proposal would defer any built-in loss on establishing the straddle until the position is closed. The proposal contains an exception from the mark-to-market treatment for stock that would be part of a straddle if the only offsetting positions to the stock are one or more qualified covered calls.

For contracts with embedded derivative components, each derivative component would be treated as a separate derivative and would be separately valued. If the embedded derivative component cannot be separately valued, the entire contract would be treated as a derivative. A debt instrument would not be treated as having a derivative component because:

- The debt is denominated in a nonfunctional currency.
- Payments are determined by reference to a nonfunctional currency.
- The debt instrument is a convertible debt instrument, a contingent payment debt instrument, a variable rate debt instrument, an integrated debt instrument, an investment unit, a debt instrument with alternative payment schedules, or another debt instrument to which the regulations under section 1275(d) apply.

The discussion draft proposal also provides that Treasury would modify the regulations to treat convertible debt instruments similarly to contingent payment debt instruments.

The discussion draft proposal would exclude the following from mark-to-market treatment:

- The list of referenced items in the definition of a derivative (e.g., stock, debt, actively traded commodities)
- A derivative with respect to a tract of real property defined in section 1237(c) or real property that would be inventory if held directly by the taxpayer
- A derivative that is part of a hedging transaction under section 1221(b) or section 988(d)(1)
- A financing transaction such as a securities lending transaction, a sale-repurchase transaction, or a similar financing transaction
- Options received in connection with the performance of services described in section 83(e)(3)
- Insurance, annuity, and endowment contracts issued by a subchapter L insurance company
- Derivatives with respect to stock issued by a member of the same worldwide affiliated group
- A contract with respect to a commodity if the contact requires physical delivery (with a cash settlement option only in unusual and exceptional circumstances) and the commodity is used in the normal course of the taxpayer's business in the quantities related in the derivative

The provision would be effective for tax years ending after 2014, in the case of property acquired and positions established after 2014, and for tax years ending after 2019, in the case of any other property or position.

KPMG observation

The discussion draft's treatment of derivatives represents a paradigm shift from the various timing and character rules for derivatives to mark-to-market timing and ordinary character. The treatment of derivatives would have a considerable impact on taxpayers who apply realization timing and capital or another special character rule to their derivatives.

Taxpayers who currently apply the special character rules of section 1256 would find their gains and losses ordinary under the discussion draft.

The discussion draft's definition of a derivative includes interests or instruments that themselves are not actively traded and that refer to property that is not actively traded. Mark-to-market valuation of such property would involve considerable judgment and

may vary significantly between taxpayers. To the extent GAAP valuations are also permissible valuations for mark-to-market federal income tax purposes, the valuation burden on taxpayers may be reduced.

Although the discussion draft provides a framework for the uniform treatment of derivative contracts, taxpayers would still need to determine whether a particular financial instrument fits the definition of a derivative and thus is subject to mark-to-market. For example, does an agreement to acquire a target corporation's stock in a planned merger constitute a derivative that must be marked to market? Several details need to be clarified including what constitutes an embedded derivative.

If implemented, application of the rules for contingent payment debt instruments to all convertible debt instruments would be a significant change from current law. Currently, convertible debt instruments typically are subject to the rules that apply to noncontingent payment debt instruments.

Hedge identification

A proposed provision (section 3402 of the draft legislation) would generally permit (1) a taxpayer's identification of a hedge for GAAP to qualify as an identification for tax, and (2) an insurance company to hedge debt instruments that are capital assets.

A transaction treated as a hedging transaction for GAAP would still have to qualify as a hedging transaction for tax.

If a GAAP hedge did not qualify as a tax hedge, the transaction would not be treated as an improperly identified tax hedge unless the taxpayer improperly treated the transaction as a tax hedge in its tax return for the tax year that included the transaction.

The provision would apply to hedging transactions entered into after 2014.

Current inclusion in income of market discount

A proposed provision (section 3411 of draft legislation) contains three changes to the market discount rules:

- Market discount would be includible in income as it accrues for all holders.
- The amount of market discount that accrues would be determined under original issue discount (OID) principles (except for debt instruments providing for multiple principal payments, to be addressed by regulations), which generally require the use of a constant yield to maturity.
- The total amount of market discount that a holder would be required to include for any accrual period would be capped at the greater of: (1) the bond's original yield to maturity plus 5%; and (2) the applicable federal rate at the time of acquisition (based

on the remaining term of the bond) plus 10% times the adjusted basis of the bond, less the amount of OID and qualified stated interest accrued during such period.

If a taxpayer disposes of a market discount bond at a loss, under the proposal, the loss would be ordinary to the extent of previously accrued market discount.

The proposal also would change the treatment of nongovernmental short-term obligations (obligations with a term not more than one year), and the treatment of certain transfers of an interest in a partnership that holds a bond.

The proposal would be effective for bonds acquired after December 31, 2014.

KPMG observation

The requirement that market discount be computed based on a constant yield to maturity and included as income currently would be a significant change from prior law. For holders of debt instruments that are exempt recipients for Form 1099 reporting purposes, the required application of the constant yield-to-maturity method would introduce additional computational difficulties. Holders of debt instruments entitled to receive Form 1099 from their broker would receive this information from their broker (although the cost basis reporting rules for certain debt instruments are not effective until 2016).

For investors in distressed debt, the inclusion of a cap, based on the purchaser's adjusted basis, on the total amount that holders must accrue would be an important change. The inclusion of the cap partially mitigates a problem under current law by limiting the amount of market discount that a holder is required to include.

Treatment of certain exchanges of debt instruments

A proposed provision (section 3412 of the draft legislation) would add a new Code section 1274B.

Under new Code section 1274B, if an issuer issued a new debt instrument in exchange for (including in a significant modification of) its existing debt instrument, the issue price of the new debt instrument would be the lesser of:

- The adjusted issue price of the existing debt instrument;
- The stated principal amount of the new debt instrument; or
- The imputed principal amount of the new debt instrument

The discussion draft proposal would also amend Code section 1037 to provide that holders of debt instruments would recognize no gain or loss if an existing debt is exchanged (including in a significant modification) solely for a new debt issued by the

same issuer. This rule would not apply to any property the holder receives that is attributable to accrued interest on the existing debt.

Finally, if a holder received cash or other property in addition to the new debt, the holder's gain would be limited to the gain that the holder would have recognized had section 1274B not applied.

The proposal would also amend language in sections 354, 355, and 356.

These changes would apply to transactions after December 31, 2014.

KPMG observation

Debt workouts are still commonplace in today's post-recession economy. This proposal would eliminate most of the adverse tax consequences that can arise for borrowers and creditors as a result of debt workouts. Thus, borrowers would not realize cancellation of indebtedness income when altering the terms of their debt instruments in a manner that results in a new debt instrument for tax purposes (for example, by extending the maturity date or changing the stated interest rate) unless the amount of the borrowing was also reduced under the new debt instrument.

Importantly, this proposal would make the publicly traded status of the borrower's new and existing debts less relevant for purposes of determining the new debt's issue price. For example, even if an issuer's new or existing debt were trading at depressed prices, the issuer would not realize cancellation of indebtedness income if it were to renegotiate the terms of its debt agreements without reducing the amount borrowed. Likewise creditors, particularly those that have acquired debt in the secondary market, would not recognize gain as a result of the restructuring, thereby eliminating the possibility that a creditor is forced to recognize non-economic or phantom tax gain.

Coordinate OID rules with financial statements

Under a proposed provision (section 3413 of the draft legislation), fees and other amounts received by a lender would be deferred no later than the tax year in which such items are included in income for financial statement purposes. This policy would be implemented by requiring taxpayers to first consider the revenue recognition rules under Code section 451 before applying the OID rules.

The provision would be effective for tax years beginning after 2014.

KPMG observation

The provision appears to be primarily directed at prepaid interest and certain fees earned by credit card issuers. For financial statement purposes, such fees are generally recognized in the period the lender originates the debt instrument. This may have a significant impact on certain financial institutions that hold credit card portfolios and issue mortgage loans that require a borrower to make a payment of prepaid interest on the loan's issue date. Currently, these amounts are deferred under the OID rules. Further, loan origination fees that otherwise qualify as OID income (e.g., points on mortgage loans) would apparently not be subject to this provision as current accounting guidelines generally require the lender to spread the income over the life of the debt instrument.

Although the provision seems to be directed at specific types of fees, the potential reach of the proposed language could be fairly broad. For example, in its current form, the proposed provision appears to apply to all income received on a debt instrument—not just fees received on the instrument's issue date. This may create administrative complexities, as tax return preparers would be required to continuously track the income recognized for financial statement purposes to confirm it does not exceed the OID accrual.

Amend rules regarding certain government debt

Under a proposed provision (section 3414 of the draft legislation), the following clerical amendments would be made to current-law rules addressing the election to recognize income currently on certain non-interest-bearing obligations:

- Repeal of Code section 454, which allows taxpayers to elect to treat the increase in the redemption value of certain obligations in income currently. The enactment of the OID rules largely made section 454 obsolete except as it relates to U.S. savings bonds, which are exempt from the application of the OID rules.
- Addition of Code section 1272A, which would allow holders of U.S. savings bonds to continue to apply the "current inclusion" election previously provided under section 454.

The provision would be effective on the date of enactment.

Determine cost basis of specified securities without regard to identification

A proposed provision (section 3421 of the draft legislation) would amend Code section 1012 to require taxpayers that sell a portion of their holdings of a "specified security" to determine gain or loss on a first-in, first-out (FIFO) basis, eliminating specific identification.

"Specified securities" would include stock, debt, options, commodities and commodity derivatives contracts (to the extent Treasury requires basis reporting for these contracts), and any other financial instruments for which Treasury requires basis reporting.

The proposal would apply on an account-by-account basis, except that multiple accounts with the same broker would be aggregated.

The proposal would not require the use of FIFO to the extent that Treasury regulations permit the use of the average cost method. Therefore, the current cost basis rules for RIC shares and stock acquired in a dividend reinvestment plan permitting the use of an average basis would not be affected.

The proposal would apply to sales, exchanges, and other dispositions after 2014.

KPMG observation

By switching to a FIFO-based identification method for all specified securities (other than those for which average basis is currently permitted), the proposal would greatly simplify cost basis reporting by brokers, who are required to apply an investor's choice of basis methods. Further, because the FIFO method applies on an account-by-account basis, a holder could still effectively specifically identify which securities it has sold by placing securities in accounts with different brokers.

Extend wash sales disallowance

A proposed provision (section 3422 of the draft legislation) would extend the wash sale disallowance rule to a related party's acquisition of substantially identical stock or securities. For purposes of the proposed wash sale rules, the term "related parties" would include:

(1) The taxpayer's spouse

(2) Any dependent of the taxpayer and any other taxpayer with respect to whom the taxpayer is a dependent

(3) Any individual, corporation, partnership, trust, or estate that controls, or is controlled by, the taxpayer or any individual described in (1) or (2)

(4) Any individual retirement account (IRA), Archer MSA, or health savings account of the taxpayer or of any individual described in (1) or (2)

(5) Any account under a qualified tuition program or a Coverdell education savings account if the taxpayer or any individual described in (1) or (2) is the designated

beneficiary of such account or has the right to make any decision with respect to the investment of any amount in such account; and

(6) Any account under a qualified retirement plan, qualified annuity plan, tax-sheltered annuity plan, or governmental eligible deferred compensation plan, if the taxpayer or any individual described in (1) or (2) with respect to the taxpayer has the right to make any decision with respect to the investment of any amount in such account

Furthermore, the proposal only provides a basis adjustment for a loss disallowed on account of an acquisition by taxpayer's spouse. Other related-party acquisitions would not trigger a basis adjustment.

The proposal would apply to all sales and other dispositions after 2014.

KPMG observation

The application of the wash sale rules to acquisitions by related parties is consistent with prior positions taken by the IRS. The fact that a basis adjustment on account of the disallowed loss is only permitted when the acquiring party is the taxpayer's spouse introduces a trap for the unwary, because in any other situation the proposal would result in a permanently disallowed loss.

The proposal does not contain a requirement that the acquiring party be aware of the taxpayer's disposition. For commonly controlled entities that have multiple entities authorized to execute trades, this proposal could cause such taxpayers to unknowingly trigger wash sales.

Tax interest on private activity bonds; eliminate federal tax credit on certain home mortgages

Under proposed provisions (sections 3431 and 3432 of the draft legislation), interest on all private activity bonds issued after December 31, 2014, would be included in gross income and subject to tax. In addition, no federal tax credits would be allowed for mortgage credit certificates issued after December 31, 2014.

The provision would be effective for private activity bonds issued after 2014 and tax years ending after 2014 with regard to mortgage credit certificates. (For more on the private activity bond provision, see the Tax-exempt bonds discussion under the "Exempt organizations" section.)

KPMG observation

Private activity bonds and mortgage credit certificates issued on or before December 31, 2014, are not affected by these changes. State and local governments are not prevented from issuing private activity bonds after 2014, but interest with respect to such bonds will no longer be exempt from tax.

Tax interest on advanced refunding bonds

A proposed provision (section 3433 of the draft legislation) would subject to tax the interest on all advanced refunding bonds. Interest on current refunding bonds would remain tax-exempt. This change would apply to advance refunding bonds issued after December 31, 2014.

Repeal certain tax credit bond rules

Under a proposed provision (section 3434 of the draft legislation), the rules related to tax credit bonds would be repealed. This includes the statutes providing for the issuance of: (1) clean renewable energy bonds; (2) new clean renewable energy bonds; (3) qualified zone academy bonds; (4) qualified forestry conservation bonds; (5) qualified energy conservation bonds; (6) qualified school construction bonds; and (7) Build America Bonds.

This provision would also repeal the election under Code section 6431 allowing issuers of tax credit bonds to receive a payment in lieu of the holder receiving a credit. The repeal would not affect the tax treatment of existing obligations.

The provision would be effective for bonds issued after the date of enactment.

KPMG observation

The federal government no longer provides new allocations for many of the bonds that would be repealed through this provision. Therefore, it may have minimal impact on the current municipal bond market. However, the provision would end recent discussions requesting the federal government to reintroduce certain bonds (such as Build America Bonds, which expired on January 1, 2011). The provision may also have a significant negative effect on participants that still receive the benefit from newly issued tax credit bonds, including public schools financed through qualified zone academy bonds and power providers that issue new clean renewable energy bonds.

Impose excise tax on systemically important financial institutions

A proposed provision (section 7004 of the draft legislation) would impose a quarterly excise tax of 0.035% on systemically important financial institutions—SIFIs—as defined under the *Dodd-Frank Wall Street Reform and Consumer Protection Act*.

This excise tax, which would apply for quarters after December 31, 2014, would be based on the SIFI's total worldwide consolidated assets as reported to the Federal Reserve in excess of a $500 billion threshold, indexed for increases in the gross domestic product. The quarterly tax would be due on the first day of the third month beginning after the close of each quarter.

The excise tax would be permanent and is expected to raise $86.4 billion in revenue over a 10-year period, according to JCT revenue estimates.

The provision would apply to calendar quarters beginning after 2014.

KPMG observation

SIFIs that would be subject to this excise tax include both bank and designated nonbank financial institutions such as insurance companies. Although only financial institutions with over $50 billion in assets may be SIFIs, this excise tax would only apply to the largest of these SIFIs—those with over $500 billion in total consolidated assets. Unlike past proposals for a bank tax that would have imposed a tax based on the bank's leverage, the excise tax under the proposal is based solely on the assets of the SIFIs in excess of the $500 billion threshold.

Other sections of the discussion draft

Other discussion draft reform proposals of interest to financial institutions and products are discussed elsewhere, including:

- Termination of special rules for gain from certain small business stock
- Nonrecognition treatment for derivative transactions by a corporation with respect to its stock
- Reform proposals for REITs and RICs

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Insurance

The discussion draft proposes changes that would affect the taxation of the insurance industry.

Computation of life insurance tax reserves

Code section 807(d)(1) provides that the deduction allowed for life insurance reserves for a contract is the greater of the net surrender value or the Federally Prescribed Reserve. Code section 807(d) currently provides that the interest rate used in computing the Federally Prescribed Reserve for a contract is the greater of the prevailing state interest rate or the 60-month rolling average of the applicable federal mid-term rate.

A proposed provision (section 3504 of the discussion draft legislation) would eliminate the prevailing state interest rate and make the discount rate the 60-month rolling average applicable federal mid-term rate plus 3.5 percentage points.

The provision would be effective for tax years beginning after 2014. The effect of the provision on computing reserves for contracts issued before the effective date would be spread over the following eight tax years.

Modify discounting rules for property and casualty (P&C) insurance companies

Pursuant to Code section 846, nonlife insurers are required to discount their unpaid losses using an interest rate equal to the 60-month rolling average of the applicable federal mid-term interest rate.

A proposed provision (section 3510 of the draft legislation) would require P&C insurance companies to use a higher rate—the corporate bond yield curve (as specified by Treasury)—to discount their unpaid losses under Code section 846.

KPMG observation

This proposal is scored as the largest insurance tax revenue-raiser and would substantially affect the computation of life insurance reserves. It would generally have the effect of reducing the deduction for life insurance reserves for a contract to the net surrender value, when the contract has a net surrender value. The rationale provided is that using a higher discount rate would "better reflect economic reality." The result of the provision would be that the computation of the reserve for tax purposes would use an interest rate greatly in excess of that used for any other purpose by the actuarial community.

In addition, the special rule that extends the loss payment pattern period for long-tail lines of business would be applied similarly to all lines of business (but without the five-year limitation on the extended period) so that:

- In general, the amount of losses that would have been treated as paid in the third year after the accident year would be treated as paid in the third year and in each subsequent year in an amount equal to the amount of the losses treated as paid in the second year after the accident year; and
- In the case of lines of business relating to auto or other liability, medical malpractice, workers' compensation, multiple peril lines, international coverage, and reinsurance, the amount of losses that would have been treated as paid in the 10th year after the accident year would be treated as paid in the 10th year and in each subsequent year in an amount equal to the amount of the losses treated as paid in the ninth year after the accident year.

The provision also would repeal the election in section 846(e) to use company-specific, rather than industry-wide, historical loss payment patterns.

The provision generally would be effective for tax years beginning after 2014, with a transition rule that would spread adjustments for pre-effective-date losses and expenses over 2014 through 2021.

KPMG observation

This proposal is scored as the second-largest insurance tax revenue-raiser and would significantly affect the computation of P&C loss reserves. The stated rationale for the modifying the discount rate to a corporate bond-based rate is to provide a "more accurate measurement of income."

The change in loss payment patterns may provide simplification, but will shorten or lengthen the pattern for different lines of business, which may or may not correspond more closely with actual loss payment patterns in the industry.

Elimination of the section 846(e) election will provide simplification, and will affect some insurers more significantly than others.

Capitalize certain policy acquisition expenses (DAC)

A proposed provision (section 3512 of the draft legislation) would substantially increase the capitalization rates applicable to specified insurance contracts under Code section 848, and would replace the current three categories of contracts with only two categories:

- Group contracts (5%)
- All other specified contracts (12%)

The 10-year spread would remain the same.

The provision would be effective for tax years beginning after 2014.

KPMG observation

When section 848 was originally enacted, there was significant debate over the appropriate capitalization percentage and amortization period. The proposal would have the effect of significantly increasing the amount of tax DAC capitalized.

Reinsurance with non-taxed affiliates

A proposed provision (section 3701 of the draft legislation) would prohibit a deduction for property and casualty reinsurance premiums paid to a related company that is not subject to U.S. taxation on the premiums, unless the related company elects to treat the premium income as effectively connected to a U.S. trade or business (and thus subject to U.S. tax).

If the taxpayer demonstrates to the IRS that a foreign jurisdiction taxes the reinsurance premiums at a rate equal to or greater than the U.S. corporate rate, the deduction for the reinsurance premiums would be allowed. Any income from reinsurance recovered by the U.S. insurance company, as well as any ceding commissions received in connection with a premium deduction that has been disallowed, would not be subject to U.S. tax.

The provision would be effective for tax years beginning after 2014.

KPMG observation

This proposal represents the latest manifestation of what has been known as the "Neal bill." The major change from prior proposals is the exception for reinsurance to jurisdictions with corporate tax rates equal to or greater than the U.S. corporate tax rate. As other countries reduce income tax rates, the high tax exclusion may not be meaningful.

Restrict exception to pro rata interest expense disallowance for corporate-owned life insurance (COLI)

A proposed provision (section 3501 of the draft legislation) would restrict the current Code section 264(f)(4) exception to the pro rata interest expense disallowance rule applicable to the unborrowed cash values of COLI. The exception would no longer apply to officers, directors, or employees, and would apply only to 20% owners of the business that holds the insurance contract.

The provision would be effective for insurance contracts issued after 2014 with any material increase in the death benefit or other material changes to existing contracts causing loss of grandfather status.

KPMG observation

This proposal is consistent with the COLI proposal that was included in the administration's 2011 through 2015 revenue proposals. The use of new COLI has generally declined in recent years, and if enacted, this provision may further reduce market demand for business-owned life insurance products.

Modify rules for life insurance proration for purposes of determining the dividends received deduction (DRD)

A proposed provision (section 3506 of the draft legislation) would change the life insurance company proration rules for the DRD in Code section 805(a)(4) by changing the proration formula to compare mean reserves to mean assets of each account, rather than the formulaic computation under current law.

The provision would be effective for tax years beginning after 2014.

KPMG observation

This proposal is consistent with the separate-account DRD proposal that was included in the administration's 2011 through 2015 revenue proposals and would essentially eliminate the separate-account DRD in most cases.

Repeal special treatment of certain health insurers

A proposed provision (section 3509 of the draft legislation) would repeal the special rules for Blue Cross Blue Shield (BCBS) and certain other health insurance organizations—i.e., the 25% deduction, the exception from the application of the 20% unearned premium haircut, and treatment as stock insurance companies.

The elimination of the 25% deduction and unearned premium haircut exemption would be effective for tax years beginning after 2014. Stock insurance company treatment would be eliminated for tax years beginning after 2016.

KPMG observation

The rationale for this proposal is that the current rules provide "preferential treatment to some health insurance providers" over others in a market in which "health insurance premiums are now regulated." This provision, if enacted, would likely affect a health insurance group's insurer fee computation under section 9010 of the Affordable Care Act.

Modify proration rules for property and casualty (P&C) insurance companies

Nonlife insurance companies are currently required to reduce the exclusion from income for tax-exempt interest income by 15% of the income. The adjustment is accomplished by a reduction in the deduction allowed for unpaid losses.

A proposed provision (section 3508 of the draft legislation) would replace the fixed 15% reduction in the reserve deduction for P&C insurance companies with a formula for reducing the reserve deduction by an amount equal to the tax-exempt income multiplied by a percentage equal to the ratio of the tax-exempt assets of the company to all assets of the company.

The provision would be effective for tax years beginning after 2014.

KPMG observation

Although the stated rationale for the suggested change from a flat P&C proration percentage to a company-based formula is to "more accurately measure" a company's reserve deduction, it is unclear how this change would achieve that end. The prior law attempted to measure the amount of tax-exempt income credited to reserves (estimated at 15%) in order to eliminate a double benefit. The disallowance in the proposed language is much broader and would create a significant disincentive to invest in state and municipal bonds.

Repeal Code section 807(f) spread

A proposed provision (section 3505 of the draft legislation) would repeal the special 10-year period for adjustments to take into account changes in a life insurance company's basis for computing reserves. The general rule for tax accounting method adjustments would apply to changes in computing reserves by life insurance companies.

The provision would be effective for tax years beginning after 2014.

KPMG observation

This proposal would put life reserve computation changes on the one-year or four-year spread rules applicable to general changes in methods of accounting.

Restrict insurance business exception to passive foreign investment company (PFIC) rules

A proposed provision (section 3703 of the draft legislation) would amend the insurance exception to the PFIC rules to apply only if (1) the PFIC would be taxed as an insurance company were it a U.S. corporation; (2) more than 50% of the PFIC's gross receipts for the tax year consist of premiums; and (3) loss and loss adjustment expenses, unearned premiums, and certain reserves constitute more than 35% of the PFIC's total assets.

The provision would be effective for tax years beginning after 2014.

KPMG observation

This proposal could have a significant impact on insurance companies that are considered "overcapitalized" and companies in runoff, among others.

Modify operations loss deductions of life insurance companies

A proposed provision (section 3502 of the draft legislation) would change the operations loss carryover and carryback periods for life insurance companies under Code section 810.

Operations losses of life companies would be carried back two tax years (instead of three) and forward up to 20 tax years (instead of 15) in conformity with the general net operating loss carryover rules.

The provision would be effective for losses arising in tax years beginning after 2014.

KPMG observation

This proposal would put life insurance companies on the same loss carryback and carryforward schedule as other corporations. A provision (section 3016) of the draft proposal would allow a loss carryback or carryforward to offset only 90% of the company's income. Combined with the effects of the proposed overall tax rate reduction and the discussion draft's section 3016 proposal, this provision could have a substantial impact on a life company's deferred tax asset admissibility computation for statutory accounting purposes.

Repeal small life insurance company deduction

A proposed provision (section 3503 of the draft legislation) would repeal the Code section 806 special deduction for small life insurance companies.

The provision would be effective for tax years beginning after 2014.

KPMG observation

This proposal is described as eliminating special treatment for a segment of the insurance industry in which "the risk distribution benefits of risk pooling are the weakest." Some question the factual foundation for this assertion. This proposal, if enacted, would not raise a significant amount of revenue. The proposal would not eliminate a similar benefit for small property and casualty insurers.

Tax reporting for life settlement transactions—clarification of tax basis of life insurance contracts

A proposed provision (section 3513 of the draft legislation) would require the purchaser of an interest in an existing life insurance contract with a death benefit equal to or exceeding $500,000 to report:

- The purchase price, the identity of the buyer and seller, and the issuer and policy number to both the IRS and the seller, and
- The identity of the buyer and seller, and the issuer and policy number to the issuing insurance company

Upon the payment of any policy benefits to the buyer of a previously issued life insurance contract, the insurance company would be required to report the gross benefit payment, the identity of the buyer, and the insurance company's estimate of the buyer's basis to the IRS and to the payee.

This provision would be effective for reportable sales of life insurance contracts and payments of death benefits occurring after 2014.

Another proposed provision (section 3514 of the draft legislation) would clarify that a taxpayer's basis in a life insurance contract would not be reduced by the cost of insurance, regardless of whether the taxpayer settles or sells the contract.

This provision would be effective for transactions entered into after August 25, 2009.

KPMG observation

This proposal is consistent with the general trend toward increased transparency in information reporting. The provision regarding computation of income upon settlement or sale of a contract would settle an ongoing computational issue between taxpayers and the IRS in favor of taxpayers.

Repeal special rule for distributions to shareholders from pre-1984 policyholders surplus accounts

A proposed provision (section 3507 of the draft legislation) would repeal the rules for distributions from pre-1984 policyholders' surplus accounts.

The provision would generally be effective for tax years beginning after 2014, and any remaining balances would be subject to tax payable in eight annual installments.

KPMG observation

This proposal, suggested by the ABA Tax Section Insurance Companies Committee, is not expected to raise much revenue.

Repeal elective deduction and related special estimated tax payment rules

A proposed provision (section 3511 of the draft legislation) would repeal the Code section 847 elective deduction and related special estimated tax payment rules.

The provision would be effective for tax years beginning after 2014.

KPMG observation

This proposal, also suggested by the ABA Tax Section Insurance Companies Committee, is not expected to raise much revenue. Code section 847 was originally enacted to provide for the admissibility of deferred tax assets associated with loss reserve discounting under the recognition rules of FAS 96.

FAS 109 liberalized these requirements, and section 847 became unnecessary and administratively burdensome.

Repeal exception from transfer-for-value rules

A proposed provision (section 3515 of the draft legislation) would repeal the exception from the transfer-for-value rules in Code section 101(a)(2) for situations where the acquirer of the life insurance contract has no substantial relationship with the insured apart from the acquirer's interest in the contract.

The provision would be effective for transfers after 2014.

KPMG observation

This proposal is designed to reach investments in life insurance contracts, and is not expected to raise much revenue.

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Multinational entities

The discussion draft contains provisions intended to address and prevent tax base erosion by currently taxing certain foreign intangible income and limiting interest expense deductions of U.S. shareholders that are members of worldwide affiliated groups. The draft also contains proposals to amend subpart F provisions and the rules relating to foreign tax credits (FTCs) and to implement a new dividends received deduction (DRD) regime, among other provisions.

Base erosion prevention

Subject foreign intangible income to taxation at reduced rate; treat intangible income as subpart F income

A provision of the discussion draft (section 4211 of the draft legislation) would modify Code section 954 and create a new category of subpart F income: foreign base company intangible income (FBCII).

FBCII would be potentially taxable to a U.S. shareholder of a controlled foreign corporation (CFC).

In conjunction with proposed revisions to the subpart F rules elsewhere in the discussion draft proposal, this new category of subpart F income would include only amounts that are subject to a low foreign tax rate.

In addition, the proposal would provide a new, phased-in deduction by adding new section 250 to the Code to reduce U.S. taxation of a U.S. corporation on income from its exploitation of intangibles in a foreign market. When fully phased in, the deduction from the gross income of the domestic corporation would be expected to result in a reduced tax rate of 15% for income from the foreign exploitation of intangible property.

KPMG observation

This provision of the proposal is described as a refinement of the international tax reform discussion draft released by the Ways and Means Committee in October 2011. It is intended to simplify the calculation of affected intangible income, and to exempt normal returns on investments in affected property, while removing the incentive to erode the U.S. tax base by locating intangible property in a low-tax jurisdiction outside the United States.

This new category of subpart F income, FBCII, would be equal to:

- The **excess** of a CFC's adjusted gross income (excluding its commodities gross income) **over** 10% of the adjusted basis of the CFC's qualified business asset investment (depreciable tangible property used in a trade or business (but excluding property used to produce commodities gross income)) for a tax year, reduced by
- The applicable percentage of the CFC's foreign personal holding company income, foreign base company sales income, foreign base company services income, and foreign base company oil-related income. The applicable percentage for this purpose is: (1) the excess of the CFC's adjusted gross income over 10% of the CFC's qualified business asset investment divided by (2) the adjusted gross income of the corporation.

The basis of any property under this proposal would be determined at the close of the year in accordance with the new rules provided elsewhere in the proposal, and without regard to any provisions enacted after the enactment of these rules.

The proposal would grant the Treasury Secretary authority to issue guidance to prevent avoidance of the application of the tangible property rules, including guidance on property that is transferred or held temporarily, and guidance when avoiding the purpose of the proposal is a factor in the transfer or holding of property.

The proposal also would add new Code section 250 to provide a new deduction for a U.S. corporation: (1) that is taxable on FBCII of a CFC; and (2) with respect to foreign intangible income earned directly (rather than through a CFC).

The amount of the allowable deduction for a year would be equal to the applicable percentage of the lesser of a domestic corporation's (1) FBCII allocable to property and services provided for ultimate use outside the United States and imputed intangible income allocable to property and services provided for ultimate use outside the United States, or (2) taxable income determined without regard to this new deduction. Intangible income would be allocated to property and services provided for ultimate use outside based upon the ratio of foreign-derived adjusted gross income (defined as income which is derived in connection with property which is sold for use, consumption, or disposition outside the United States or services provided with respect to persons or property located outside the United States) to total adjusted gross income for the year.

Under the proposal, the applicable percentage would be 55% for tax years beginning in 2015 and would be reduced in conjunction with the phase-in of the 25% corporate rate as follows:

- 52% in 2016
- 48% in 2017

- 44% in 2018
- 40% for tax years beginning in 2019 or thereafter.

The rules on taxation of FBCII to a U.S. shareholder of a CFC would be effective for tax years of a CFC beginning after 2014, and for tax years of a U.S. shareholder in which or with which such tax years of the CFC end. The rules allowing a deduction of a percentage of FBCII and of directly earned foreign intangible income would be effective for tax years beginning after 2014.

According to the Joint Committee on Taxation (JCT), this provision—along with the FTC measures of the discussion draft—would increase revenues by $115.6 billion over the 2014-2023 period.

Deny deduction for interest expense of U.S. shareholders that are members of worldwide affiliated groups with excess domestic indebtedness

A provision of the discussion draft (section 4212 of the draft legislation) would amend Code section 163 to add a new section 163(n) and potentially limit the amount of deductible interest expense of a U.S. corporation that is a U.S. shareholder (as defined in Code section 951(b)) with one or more foreign corporations when the U.S. and foreign corporations are members of the same worldwide affiliated group.

The proposal would not apply to a group consisting only of domestic corporations.

The proposal would be intended:

- To reduce the incentive for U.S. corporations to maintain excessive leverage
- To prevent U.S. corporations from generating excessive interest deductions and incurring disproportionate amounts of debt to produce exempt foreign income under the proposed dividend-exemption system

The proposal focuses on two indicia of excessive leverage: (1) indebtedness of a U.S. corporation that exceeds the level of the indebtedness of a worldwide affiliated group (comprising related U.S. and foreign entities) and (2) net interest expense of a U.S. corporation that exceeds a prescribed percentage of the U.S. corporation's adjusted taxable income. Affiliated corporations would be treated as one taxpayer for purposes of testing under this rule.

Very generally, a portion of otherwise deductible interest of a U.S. corporation would be disallowed by the lesser of: (1) the extent a U.S. group's net interest expense is attributable to debt in excess of 110% of the debt-to-equity ratio of the worldwide affiliated group or (2) the extent to which net interest expense exceeds 40% of adjusted taxable income of the U.S. corporation.

Disallowed interest expense in a tax year could be carried forward to a subsequent tax year.

The proposal would provide authority for appropriate regulations to carry out the purposes of this proposal, including prevention of avoidance, modification of affiliated group determinations, coordination with the branch profits tax under section 884, and reallocation of shares of partnership indebtedness, or distributive shares of a partnership's interest income or interest expense.

This proposal also would provide coordination with section 163(j) and would provide generally that the amount disallowed under section 163(j)(1)(A) would be reduced by the amount of any reduction under this proposal.

This provision would be effective for tax years beginning after 2014.

The JCT estimates that this provision would increase revenues by $24 billion over the period from 2014-2023.

Amendments to subpart F

Changes in threshold in the high tax exception to subpart F income; exception no longer optional

A proposed provision (section 4201 of the draft legislation) would amend Code section 954 (and Code section 953) by changing the tax rate threshold that must be met in order for the high tax exception to subpart F income to apply.

Under the exception, an item of income is not treated as foreign base company income or insurance income for purposes of subpart F if it has been taxed at or above a threshold rate of foreign tax.

The proposal would change the threshold rate as follows:

- For foreign personal holding company income (FPHCI), foreign base company services income, and insurance income—from 90% to 100% of the maximum corporate U.S. tax rate (i.e., from a 31.5% to 25% tax rate)
- For foreign base company sales income (FBCSI)—from 90% to 50% of the maximum corporate U.S. tax rate (i.e., from 31.5% to 12.5% tax rate)

KPMG observation

Changes proposed under this provision, in conjunction with the reduced maximum corporate rate, would result in lower thresholds for meeting the high tax exception, with the most favorable treatment provided for FBCSI (note also the favorable provisions for FBCSI introduced in section 4202 of the proposal and discussed below). The intent of these changes is to ensure that subpart F provisions apply only to low-taxed foreign base company income (and insurance income).

The provision (discussion draft section 4201) would also amend Code section 954 to establish the high tax exception threshold for foreign base company intangible income—a new category of subpart F income introduced in section 4211 of the proposal.

Subpart F income would generally not include the foreign percentage of foreign base company intangible income if such income (treated as a single item of income) is subject to a foreign effective tax which is at or above 60% of the maximum corporate U.S. tax rate.

This threshold would be phased in as follows:

- 45% for tax years beginning in 2015
- 48% in 2016
- 52% in 2017
- 56% in 2018
- 60% for tax years beginning in 2019 and thereafter

KPMG observation

FBCII other than the foreign percentage of such income (i.e., FBCII income generated from U.S. sources) generally would be excluded from subpart F income because it would meet the general 100% high-tax exception threshold. In the end, according to JCT, foreign base company intangible income would only be subpart F income under the proposal "to the extent that the income is subject to a foreign effective tax rate lower than the effective U.S. tax rate imposed after taking into account the deduction for foreign intangible income" discussed in discussion draft section 4211 (proposed Code section 250).

The changes would apply to tax years of foreign corporations beginning after December 31, 2014, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

KPMG observation

The proposal and the JCT commentary make it clear that the high tax exception is no longer an elective provision. Eliminating electivity for the exception presumably is intended to prevent cross-crediting of foreign taxes on income taxed at foreign rates higher than the applicable U.S. rates.

According to JCT, this provision, along with discussion draft sections 4211, 4103, 4202, and 4203, would increase revenues by $115.6 billion over 2014-2023.

Exclusion of 50% of FBCSI from subpart F and preservation of related FTCs; exclusion of 100% of FBCSI earned by qualified residents of a U.S. tax treaty jurisdiction

A provision (section 4202 of the draft legislation) would amend Code section 954 to include only 50% of FBCSI in foreign base company income and consequently subpart F income.

KPMG observation

This provision results in the exclusion from subpart F of 50% of low-taxed FBCSI, i.e., 50% of FBCSI that is not already excluded by virtue of meeting the modified 12.5% high tax exception threshold.

This proposal would amend Code section 960 so that all 100% (and not just 50%) of the low-taxed FBCSI is deemed to be included under section 951(a)(1) for purposes of calculating accompanying FTCs.

KPMG observation

The JCT expects that foreign taxes paid by the CFC with respect to the excluded 50% of FBCSI would remain creditable as deemed paid taxes. This proposed amendment to section 960 may be particularly relevant in light of the other amendments to the FTC rules.

Finally, the proposal provides that all FBCSI of a CFC would be excluded from subpart F if the CFC is eligible as a qualified resident for all of the benefits provided under a comprehensive income tax treaty with the United States.

KPMG observation

According to JCT, a "comprehensive income tax treaty" refers to any bilateral treaty for the elimination of double income taxation, and the scope of this provision is intended to be limited to those companies that satisfy the limitation on benefits provisions of income tax treaties.

The amendments would apply to tax years of foreign corporations beginning after December 31, 2014, and to tax years of U.S. shareholders in which or with which those taxable years of foreign corporations end.

According to JCT, this provision, along with the discussion draft's proposed sections 4211, 4103, 4201, and 4203, would increase revenues by $115.6 billion over 2014-2023.

Inflation adjustment of the de minimis exception for foreign base company income

A proposed provision (section 4203 of the draft legislation) would amend Code section 954 to require an inflation adjustment to the $1 million de minimis amount in the case of any tax year beginning after 2015, with all increases rounded to the nearest multiple of $50,000.

The proposal would be effective for tax years of foreign corporations beginning after December 31, 2014, and to tax years of U.S. shareholders within which or with which such tax years of foreign corporations end.

According to JCT, this provision, along with discussion draft sections 4211, 4103, 4201, and 4202, would increase revenues by $115.6 billion over 2014-2023.

Extend active financing exception, with a 50% limitation for low-taxed income and preservation of corresponding FTCs

A provision (section 4204) of the proposal would, subject to modifications described below, extend for five years the exceptions from FPHCI, foreign base company services income, and insurance income, for certain income derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business.

The proposal would amend Code section 954(h) and (i) to provide that FPHCI (and consequently foreign base company services income per section 954(e)(2)) would not include any item of qualified banking or financing income of an eligible CFC or qualifying insurance income of a qualifying insurance company—if such income is subject to an effective foreign income tax rate of at least 50% of the maximum U.S. corporate rate (i.e., if it meets the 12.5% tax rate threshold). Further, the proposal would exclude from FPHCI (and foreign base company services income) 50% of any other item of qualified banking or financing income of an eligible CFC, or qualifying insurance income of a qualifying insurance company.

KPMG observation

As a result, according to JCT, the high-taxed active financing income would be exempt, and low-taxed active financing income would be subject to a reduced U.S. tax rate of 12.5%, before the application of FTCs.

The proposal would amend section 960 of the Code to ignore the exclusion of 50% of the low-taxed active financing and insurance income. Thus, the determination of taxes deemed paid under section 960(a) would be made as if no 50% exclusion were allowed.

KPMG observation

The JCT expects that a U.S. shareholder would therefore be deemed to pay the pro rata share of the full amount of tax paid by the respective subsidiary on the qualifying banking, financing, or insurance income.

The amendments under discussion draft section 4204 would apply to tax years of foreign corporations beginning after December 31, 2013, and to tax years of U.S. shareholders in which or with which such tax years of foreign corporations end. The modified active financing and insurance exceptions in Code section 954(h), (i), and (e), and section 953(e) would be extended to years of the foreign corporation beginning before January 1, 2019, and to tax years of U.S. shareholders with or within which any such tax year of such foreign corporation ends.

According to JCT, this provision would reduce revenues by $18.4 billion over 2014-2023.

Repeal section 955 of the Code—no inclusion based on withdrawal of previously excluded subpart F income from qualified investment

The proposal (section 4205 of the discussion draft) would repeal section 955 of the Code. As a result, there would no longer be current U.S. tax imposed on previously excluded foreign shipping income of a foreign subsidiary if there was a net decrease in qualified shipping investments.

The amendments under section 4205 (i.e., the repeal of section 955) would apply to taxable years of foreign corporations beginning after December 31, 2014, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

According to JCT, this provision would increase revenues by less than $50 million over 2014-2023.

Amendments to rules relating to FTCs

Repeal section 902 and require determination of section 960 credit on a current-year basis

A provision of the discussion draft proposal (section 4101 of the draft legislation) would repeal Code section 902, which deems a U.S. corporate shareholder of a 10% owned foreign corporation to have paid a portion of the foreign corporation's taxes when it receives or is deemed to receive a dividend from that foreign corporation.

The proposal would retain the deemed paid credit under section 960 for subpart F inclusions, but would compute the allowable credit based on current-year taxes rather than under the section 902 "pooling" approach.

Under the JCT report, the IRS and Treasury would be directed to provide rules for allocating taxes to subpart F inclusions. The JCT report anticipates that those rules would be similar to the rules in current Reg. section 1.904-6 for allocating taxes to separate section 904(d) categories of income. For example, if income treated as subpart F income for U.S. purposes is not subject to foreign tax, no taxes would be attributable and deemed paid with respect to a subpart F inclusion.

To the extent foreign taxes attributable to a subpart F inclusion are not claimed as credits in the year of the subpart F inclusion—for example, because they arise on a distribution of previously taxed income (PTI) from a lower-tier to an upper-tier CFC—these foreign taxes would be allowed as credits under section 960 in the year the PTI is distributed. The section 960 credit, as under current law, would be computed separately for each separate category of income under section 904(d).

The proposal would make conforming amendments to other Code provisions to reflect the repeal of section 902, including:

- Amending section 78 to treat the "gross-up" for deemed paid taxes as an additional section 951(a) inclusion rather than a dividend
- Repealing section 1293(f), which allowed a deemed paid credit under section 960 for qualified electing fund inclusions
- Amending section 909 to apply to direct foreign taxes and foreign taxes that would be deemed paid under section 960

The amendments are proposed to be effective for tax years of foreign corporations beginning after December 31, 2014, and to tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

KPMG observation

The repeal of section 902 would have significant consequences for section 902 corporations (referred to as "qualified 10 percent owned foreign corporations" in the discussion draft proposal) because no taxes paid or accrued by such corporations could be claimed as FTCs.

The Ways and Means chairman's proposal appears to be substantively the same as the November 2013 Finance chairman's draft proposal, with one exception. The Ways and Means chairman's proposal would retain section 909 for direct foreign taxes, while the Finance chairman's proposal would repeal section 909.

Apply FTC limitation by allocating only directly allocable deductions to foreign source income

A provision in the discussion draft (section 4102 of the draft legislation) would add new Code section 904(b)(3), providing that for purposes of computing the FTC limitation, only directly allocable deductions would be subtracted from foreign source gross income to arrive at foreign source taxable income.

Directly allocable expenses would include salaries of sales personnel, supplies, and shipping expenses directly related to producing foreign source income. Examples of expenses that would not be directly related to producing foreign source income and, thus, would not reduce foreign source gross income for FTC purposes include general and administrative expenses, stewardship expenses and interest expense.

The amendments are proposed to be effective for tax years of foreign corporations beginning after December 31, 2014, and to tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

KPMG observation

This proposal is viewed as "taxpayer favorable" because it would result in more foreign-source taxable income and thus a higher FTC limitation than if indirect expenses were applied to reduce foreign income. Expenses that do not reduce foreign-source income would not be disallowed and, thus, would reduce worldwide taxable income in the denominator of the FTC limitation fraction.

Expand passive category income to include other mobile income

A provision in the discussion draft (section 4103 of the draft legislation) would retain the two separate categories of income under Code section 904(d), but would rename the passive category as the mobile income category and expand the former passive category to include foreign base company sales income and FBCII.

Mobile category income also would include financial services income.

Excess foreign taxes carried over from a pre-effective date year would be subject to the new rules, and regulatory authority would be provided for the IRS and Treasury to provide for the allocation of excess credit carry backs from post- to pre-effective-date years.

These amendments are proposed to be effective for tax years of foreign corporations beginning after December 31, 2014, and to tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

KPMG observation

Under current law, the general category in most cases includes active business income while the passive category includes investment type income. The proposal appears to move away from an active/passive approach and toward a low-tax/high-tax approach. The revised categories of subpart F income that would fall within the mobile category generally would be defined to include only income taxed at a rate less than 50% of the U.S. rate without regard to whether earned as part of an active trade or business. Financial services income, although derived as part of an active business, generally is low-taxed compared to other types of active business income.

Determine source of income from sales of inventory solely on basis of production activities

A provision of the discussion draft (section 4104 of the draft legislation) would revise the current general rule under current Code section 863(b), which sources income from inventory property produced in one jurisdiction and sold in another jurisdiction by allocating 50% of sales income to the place of production and 50% to the place of sale (determined based on title passage). Under the proposed change, income from inventory sales would be sourced entirely based on the place of production. Thus, if inventory property is produced in the United States and sold outside of the United States, sales income would be 100% U.S. source. If inventory property is produced partly within and partly outside of the United States, income from sales would be partly U.S. source and partly foreign source.

KPMG observation

The proposed change would produce a more economically realistic result as compared with the current rule, which relies on the easily manipulable title passage rule. It is unknown, though, whether it could have the unintended result of encouraging companies to expand foreign production.

U.S. participation exemption regime

As mentioned above, the discussion draft would implement a new 95% DRD regime for dividend distributions from CFCs.

Add new DRD regime

A provision (section 4001) of the draft legislation would add new section 245A to the Code.

Code section 245A would entitle a domestic corporation that owns more than 10% of the voting power of a foreign corporation (ownership may be direct or indirect) to a 95% DRD against the foreign-source portion of a dividend received from the foreign corporation (the "245A DRD").

The portion of a dividend treated as foreign-source would be in the same proportion as the foreign corporation's foreign-source income bears to its total earnings. A foreign corporation's foreign earnings would be all earnings except income effectively connected to a U.S. trade or business or dividend income received from an 80% owned domestic corporation (ownership may be direct or through a wholly owned foreign corporation).

No FTC or deduction for foreign tax paid or accrued would be allowed with respect to any dividend allowed a 245A DRD. For purposes of calculating a section 904(a) FTC limitation of a domestic corporation allowed a 245A DRD, the entire foreign-source portion of the dividend is excluded from net foreign-source income. Additionally, no deductions are allocable against the exempt dividend income.

KPMG observation

The disallowance of FTCs or deductions for foreign income tax paid or accrued would apply to all income taxes paid or accrued with respect to the foreign- source portion of a 245A dividend, including applicable withholding taxes. Additionally, this disallowance would apply with respect to the entire amount of taxes paid with respect to the foreign-source portion of a dividend allowed a 245A DRD even though the 245A DRD offsets only 95% of the foreign-source portion of such dividend.

In addition to owning 10% of the voting power, a domestic corporation would need to satisfy additional requirements in order to benefit from the 245A DRD.

- The domestic corporation would have to satisfy a holding period with respect to the foreign corporation stock in order to be eligible for a 245A DRD on a dividend received from the foreign corporation. Specifically, a domestic corporation would have to hold the shares of the foreign corporation for more than 180 days during the 361-day period beginning 180 days before the dividend is paid.
- A 245A DRD would not be permitted to the extent that the domestic corporation that owns the shares with respect to which the dividend is paid is under an obligation to make related payments with respect to positions in substantially similar or related property.

Several conforming amendments would be made to coordinate the 245A DRD with existing Code provisions.

- A 245A DRD would not be available for any dividend from a corporation exempt from tax under Code sections 501 or 521.
- Section 864(e)(3), which provides that tax-exempt assets are not taken into account for purposes of performing a U.S. shareholder's expense allocation and apportionment, would be amended to include a cross-reference to new section 245A. Consequently, for purposes of that section, 95% of the foreign corporation stock would be considered a tax-exempt asset and excluded from the analysis.
- Section 1059, under which a corporate shareholder's basis in stock is reduced by the non-taxed portion of extraordinary dividends received, would be coordinated with new section 245A in that a corporation that receives an extraordinary dividend in respect of stock that the corporation has not held for more than two years before the dividend announcement date would be required to reduce its basis in the stock by the amount of the 245A DRD.

The 245A DRD provisions would generally be effective for tax years of foreign corporations beginning after December 31, 2014, and to tax years of U.S. shareholders in which or with which those tax years of foreign corporations end.

Create loss limitation with respect to specified 10% owned foreign corporations

A provision (section 4002 of the draft legislation) would create loss limitation rules with respect to foreign corporations.

- First, through amendment to Code section 961, the proposal, solely for the purposes of determining loss, would require a domestic corporation that owns more than 10% (directly or indirectly) of a foreign corporation to adjust its tax basis in the foreign corporation stock by reducing that basis by an amount equal to the 245A DRD received on dividends from the foreign corporation.
- Second, the legislation would add Code section 92, with additional conforming amendments, that would create rules regarding income inclusions for the amounts of losses transferred in certain transactions. Under proposed section 92, if a domestic corporation transfers substantially all the assets of a foreign branch (within the meaning of section 367(a)(3)(C)) to a foreign corporation of which it is a United States shareholder, the domestic corporation would have an inclusion to gross income equal to the "transferred loss amount" with respect to such transfer.

The transferred loss amount (TLA) is defined as the excess (if any) of:

- The sum of losses incurred by the foreign branch and allowed as a deduction to the domestic corporation after December 31, 2014, and before the transfer, over

- The sum of (1) any taxable income of such branch for a tax year after the tax year in which the loss was incurred, through the tax year of the transfer, and (2) any amount recognized under section 904(f)(3) on account of the transfer.

The amount of the domestic corporation's income inclusion under this proposal would be subject to limitations.

A domestic corporation's gross income inclusion under this provision would be limited to the aggregate of 245A DRDs allowable to the domestic corporation, taking into account all of the domestic corporation's 10% owned foreign corporations.

Transfer loss amounts (TLAs) excluded from gross income under this provision would be carried forward with inclusion in subsequent year's gross income subject to this same limitation.

- For transfers covered by section 367(a)(3)(C), the TLA would be reduced by the amount of gain recognized by reason of such subparagraph.
- For transfers not covered by section 367(a)(3)(C), the TLA would be reduced by the amount of gain recognized by the domestic corporation on the transfer.

Amounts included in gross income by a domestic corporation under section 92 or by reason of section 367(a)(3)(C) would be treated as foreign-source gross income. Proper adjustments to the foreign corporation's adjusted basis or to the basis of the transferred property would be governed by future regulations or guidance.

The proposal requiring basis adjustments to a foreign corporation's stock would be effective for dividends received after December 31, 2014.

The proposal relating to TLAs from foreign branches upon asset transfers to foreign corporations would be effective for transfers after December 31, 2014.

Transition to exemption system: amend treatment of deferred income

A provision (section 4003 of the draft legislation) would amend Code section 965 to subject any U.S. shareholder owning 10% of a foreign corporation to a deemed repatriation of the undistributed and untaxed foreign earnings ("deferred E&P") of foreign corporations for the last tax year of the foreign corporation ending before January 1, 2015.

KPMG observation

Notably, the amended section 965 transition rule will apply to all U.S. shareholders that own 10% of a foreign corporation—not only shareholders that are domestic corporations.

The section 965 transition rule would create a deemed repatriation of a foreign corporation's deferred E&P to its 10% U.S. shareholders by increasing the foreign corporation's subpart F income by the amount of deferred E&P. Thus, a 10% U.S. shareholder of a foreign corporation would include in income its pro rata share of the foreign corporation's subpart F income, which includes the increase for the deferred E&P.

The 10% U.S. shareholder would be allowed a deduction against its pro rata share of the deferred E&P inclusion by reference to the portion of the deferred E&P held in cash or liquid assets. A 90% deduction is allowed for the non-cash portion of the deferred E&P, and a 75% deduction is allowed for the cash portion of the deferred E&P. Post deduction, this income inclusion will be taxed at the U.S. shareholder's ordinary income tax rates in effect prior to the implementation of this proposal.

KPMG observation

For example, a domestic corporation owning more than 10% of a foreign corporation would be subject to an 8.75% tax rate on deferred E&P attributable to cash and a 3.5% tax rate on all other deferred E&P.

Additionally, as deferred E&P is considered an increase to a foreign corporation's subpart F income, for purposes of determining a U.S. shareholder's income inclusion, a noncontrolled 10/50 company would be treated as a CFC.

A U.S. shareholder's income inclusion under this transition rule would be reduced by the U.S. shareholder's share of earnings deficits in the earnings of other foreign corporations it owns as of February 26, 2014.

No U.S. tax benefit for the foreign tax expense allocable to the deductible portion of the deferred E&P would be allowed, either as a credit or deduction. Correspondingly, the taxpayer would not be required to gross-up the deductible portion of the deferred E&P under section 78.

A 10% U.S. shareholder may elect to pay the tax due on the repatriated earnings in up to eight installments, subject to an acceleration rule applicable upon certain events limiting the government's ability to collect the tax due.

The proposal also contains a special rule for the shareholders of S corporations that are themselves 10% U.S. shareholders of foreign corporations. This rule would allow the shareholders of the S corporations to elect deferral on their portion of the net tax liability from the deemed repatriation of the foreign corporation's deferred E&P until a triggering event occurs. Triggering events include: (1) change in S corporation status, (2) liquidation, sale, or end of the S corporation's business, or (3) shareholder disposition of S corporation shares.

KPMG observation

This proposal does not allow a special rule for partners in a U.S. partnership that own foreign corporation stock the option to defer the net tax liability under this transition rule. As such, U.S. shareholders that own foreign corporation stock directly or through a US partnership could consider pre-effective-date planning to obtain the deferral benefit provided by this special rule for S corporations.

Permanently extend section 954(c)(6) look-through rule for related CFCs

A provision (section 4004 of the draft legislation) would make permanent the exclusion from the definition of foreign personal holding company income the receipt of certain dividends, interest, rents, and royalties from related parties under Code section 954(c)(6). The amendment would be effective for the tax years of foreign corporations beginning after December 31, 2013.

KPMG observation

While the amendment of section 954(c)(6) would exclude from the definition of foreign personal holding company income the receipt of certain dividends, interest, rents, and royalties from related parties, taxpayers need to carefully analyze existing transaction flows to determine that these types of related-party payments will not generate subpart F inclusions under this proposal's updated subpart F regime—in particular, the provision creating FBCII. While section 954(c)(6) exempts certain related-party payments from the definition of foreign personal holding company income specifically, it would not exempt similar related-party payments from other types of subpart F income.

Other provisions

Exclude CFC dividends from personal holding company income

A provision (section 3661 of the draft legislation) would exclude dividends paid by controlled foreign corporations (CFCs) from the definition of personal holding company income under Code section 543(a)(1).

This provision is best understood in the context of the other parts of the proposal.

Specifically, section 4001 of the discussion draft would provide a 95% dividends received deduction (DRD) for dividend distributions from CFCs. As a practical matter under the Code section 959 rules, if a distribution from a CFC is treated as a dividend, then it necessarily is not a distribution of earnings that were previously taxed under the subpart F regime. Thus, the distribution of a dividend would represent a distribution of

non-subpart F earnings, which under section 4001 would be eligible for a 95% exemption via the DRD.

Because the "personal holding company" definition is determined on a gross income basis, however, the 95% DRD would not prevent the gross amount of the dividend inclusion from being taken into account for personal holding company income purposes. The proposal thus would prevent such dividends, which otherwise generally would be subject to an exemption system under section 4001 of the discussion draft, from technically being taken into account as personal holding company income.

The proposed change also would underscore the macro-level policy, embodied by section 4001 of the discussion draft, that non-subpart F earnings of a CFC are generally considered to arise from an active business operation.

The provision would be effective for tax years beginning after December 31, 2014.

Modify taxation of passenger cruise lines

A proposed provision (section 3702 of the draft legislation) would modify the taxation of income earned from the transportation of passengers aboard cruise ships on "covered voyages" (as defined in Code section 4472).

Ordinarily, U.S.-source income derived by foreign ship operators or lessors for transporting passengers and goods in international traffic (meaning the voyage begins or ends within the United States, but not both) is not subject to tax if the country of the foreign corporation's organization provides a "reciprocal exemption." Cruise ship voyages that begin at a U.S. port and end at a foreign port, or vice versa, thus qualify for this standard.

If a reciprocal exemption does not apply, then typically a 4% excise tax on a specified amount of income is imposed, in lieu of the traditional inbound taxation rules for service providers. The excise tax does not apply, however, and instead the relevant income is treated as effectively connected, when the foreign ship operator has a fixed place of business in the United States that is involved with earning the transportation income, and substantially all of the corporation's transportation income is attributable to regularly scheduled transportation.

The proposal would remove passenger cruise transportation income from the special inbound shipping tax regime and instead treat it as effectively connected income, even if the foreign corporation does not have a U.S. fixed base or sufficient regularly scheduled transportation.

The changes would be effective for tax years beginning after December 31, 2014.

KPMG observation

The Ways and Means staff summary states that one of the reasons for these proposed changes is that cruise operators impose a substantial resource burden on the U.S. Coast Guard and the U.S. maritime infrastructure, while the foreign operators typically pay little to no U.S. tax. The staff summary also asserts that given the pricing and capacity metrics within the cruise line industry, the proposal's drafters considered it unlikely that the cost of the increased taxes would simply be passed on to the passengers.

Foreign shipping or cruise line companies that are qualified residents of applicable treaty jurisdictions are also entitled to an exemption from most or all of their U.S.-source transportation income under Article 8 (Shipping and Air Transport) of U.S. income tax treaties. Nothing in the legislative text or Ways and Means staff summary suggests that this proposal would be intended to overturn that benefit. Thus, it would presumably only affect non-treaty resident foreign cruise line enterprises.

Limit treaty benefits for certain deductible payments

A proposed provision (section 3705 of the draft legislation) would add new Code section 894(d) that would deny applicable treaty benefits to, and thus impose the full 30% gross withholding tax upon, certain deductible payments made by a U.S. person to a foreign related person.

The treaty override provision would apply if the payor and payee are indirectly commonly controlled by a foreign common parent corporation that is not itself eligible for treaty benefits.

KPMG observation

The Ways and Means discussion draft proposal appears to require only that the foreign common parent be eligible for treaty benefits of some kind, and thus would not require a rate comparison between the withholding tax imposed on the actual payment and the withholding tax that would be imposed upon a hypothetical payment to the foreign common parent.

The change would apply immediately to payments made after the date of enactment. The JCT estimates that it would raise $6.9 billion over the following 10 years.

KPMG observation

Similar proposals have been introduced numerous times over the past few years, without success. In practical terms, many companies that might have been affected by the provision have already responded by reorganizing their corporate structure so that their ultimate parent company is resident in a treaty jurisdiction.

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

The discussion draft proposal would:

- Deny a U.S. insurance company a deduction for reinsurance premiums paid to a related company that is not subject to U.S. tax on the premiums, unless the taxpayer can demonstrate to the IRS that a foreign jurisdiction taxes the premiums at a rate at least as high as the U.S. corporate rate; and
- Exclude from the insurance company's income any reinsurance recovered or ceding commissions received with respect to reinsurance policies for which a premium deduction is denied

A foreign corporation that receives a premium from an affiliate that would otherwise be denied a deduction under this proposal would be permitted to elect to treat the premium and the associated investment income as income effectively connected with the conduct of a trade or business in the United States, and attributable to a permanent establishment for tax treaty purposes. The electing reinsurer would be subject to tax under Code section 842.

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

The proposal would be effective for tax years beginning after December 31, 2014.

KPMG observation

The administration and others have made similar proposals in the last few years. Although the disallowance of the U.S. company's deduction for reinsurance premium paid is often described as a deduction deferral mechanism—not a disallowance mechanism—the forgone deduction for reinsurance may or may not be fully offset by the exclusion of the associated reinsurance recoverable or ceding commission, and the timing of recovery of these items is uncertain.

On the other hand, 100% of reinsurance recoverable and ceding commissions may be excluded from the ceding company's income regardless of whether such amounts are less than, or exceed, the disallowed deduction for the reinsurance premium paid.

Restrict insurance business exception to PFIC rules

Under the proposed provision, income derived by a foreign corporation in the active conduct of an insurance business would not be treated as passive income for purposes of the passive foreign investment company (PFIC) rules only if:

- More than 50% of the corporation's gross receipts for the tax year consist of premiums, and
- Loss and loss adjustment expenses, unearned premiums, and certain reserves constitute more than 35% of the corporation's total assets

The provision would be effective for tax years beginning after December 31, 2014.

KPMG observation

Under current law, income derived by a foreign corporation in the active conduct of an insurance business qualifies for an exception from passive income if the corporation is "predominantly engaged" in an insurance business. The provision would create a "bright-line test" for that determination, under which some foreign corporations may no longer qualify for the exception.

Tighten limitation on earnings stripping

The proposal would reduce the 50% of adjusted taxable income threshold for the limitation to 40%. In addition, the carryforward of excess limitation would be eliminated.

The proposal would be effective for tax years beginning after December 31, 2014.

KPMG observation

The administration previously proposed tightening the limitation on earnings stripping. The JCT explanation of the administration's fiscal year 2013 budget proposal discusses in detail the stripping of earnings by entities, particularly those which inverted successfully prior to the effective date of section 7874, including a thorough analysis of a Treasury report prepared to evaluate the impact of earnings stripping.

The JCT explanation points out that the administration's proposal did not address earnings stripping transactions involving the payment of deductible amounts other than interest (e.g., rents, royalties, reinsurance premiums, and service fees) or the payment of deductible amounts by taxpayers other than corporations. The JCT explanation states that "[t]hese transactions also may erode the U.S. tax base, and thus some argue that a more comprehensive response to earnings stripping is needed." The JCT

explanation does not offer any specific proposals, however, with respect to these other types of payments.

Other provisions in the discussion draft that may affect multinational entities include sections 3648 (relating to the application of FIRPTA to sales of shares in RICs or REITs) and 3649 (relating to the availability of a DRD under section 245(a)(5)(B) for dividends received from RICs and REITs, discussed above).

For more information, contact a tax professional with the International Tax group of KPMG's Washington National Tax:

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Exempt organizations

The discussion draft proposes a number of changes that would affect tax-exempt organizations. Unless otherwise stated, all provisions would be effective for tax years beginning after 2014.

Impose excise tax on excess tax-exempt organization executive compensation

A new provision would impose a 25% excise tax on compensation in excess of $1 million paid by a tax-exempt organization to any of its five highest-paid employees for the tax year. A more detailed explanation is available under Executive compensation in the "business and industry section".

Clarify UBIT treatment

Under the discussion draft proposals, the unrelated business income tax (UBIT) would apply to all organizations exempt under Code section 501(a)—even if an organization is also exempt or excludes amounts from gross income by reason of another provision.

For example, a state pension fund may have a ruling that it is exempt under section 501(a) and may also exclude its income from tax by reason of section 115(1). Under the proposal, the state pension fund would be subject to the unrelated business income tax.

Treat name and logo royalties as unrelated business taxable income (UBTI)

The discussion draft proposes treating the sale or license of a tax-exempt organization's name or logo (including any related trademark or copyright) as a per se unrelated trade or business and treating any royalty income as UBTI.

Compute UBTI separately for each trade or business activity

Under the discussion draft, a tax-exempt organization would be required to calculate separate the net UBTI of each unrelated trade or business. Any loss derived from one unrelated trade or business could only be used to offset income from that unrelated trade or business, with any unused loss subject to the general rules for net operating losses (NOLs).

As proposed, any NOLs generated prior to 2015 could be carried forward to offset income from any unrelated trade or business, but NOLs generated after 2014 could be carried back only to offset income with respect to the unrelated trade or business from which the NOL arose.

Limit exclusion of research income limited to publicly available research

The discussion draft proposes limiting the exception from UBTI for fundamental research to income derived from research made available to the public.

Limit charitable contributions for tax exempt organizations and trusts

Under the discussion draft, the charitable contribution deduction for purposes of determining unrelated UBTI would be limited to 10% of taxable income for both tax-exempt corporations and tax-exempt trusts.

Increase specific deduction for UBIT

The discussion draft proposes increasing the deduction against UBTI from $1,000 to $10,000.

Repeal exclusion of gain or loss from disposition of distressed property

Under the discussion draft, the exclusion from UBTI for gains and losses from the sale of distressed property (i.e., certain real property acquired by the tax-exempt

organization from a bank or savings and loan association that held the property in receivership or conservatorship or as a result of a foreclosure) would be repealed.

Modify qualified sponsorship payments

The discussion draft proposes two modifications to the exception from UBTI for qualified sponsorship payments.

- First, if the use or acknowledgement refers to any of the sponsor's product lines, the payment would be treated as income from an advertising trade or business, a per se unrelated trade or business that is subject to UBTI.
- Second, if a tax-exempt organization receives more than $25,000 of qualified sponsorship payments for any one event, any use or acknowledgement of a sponsor's name or logo could appear only with and in substantially the same manner as the names of a significant portion of the other donors to the event.

Increase certain penalties

Under the discussion draft, the penalties on tax-exempt organizations and their managers for failure to file various returns, disclosures, or public documents would be increased, including the following:

Failure	Current penalty	Proposed penalty
Organization's failure to file information return	$20 per day	$40 per day
Large organization's (> $1 million gross receipts) failure to file information return	$100 per day	$200 per day
Manager's failure to comply	$10 per day	$20 per day
Individual's failure to comply with public inspection requirements	$20 per day	$40 per day

These provisions would be effective for information returns required to be filed on or after January 1, 2015.

Impose manager-level accuracy-related penalty on underpayment of UBIT

A new provision would impose a 5% penalty, not to exceed $20,000, on managers of a tax-exempt organization when an accuracy-related penalty is applied to the organization for any substantial understatement of UBIT. The new provision also would apply a 10% penalty, not to exceed $40,000, on managers of a tax-exempt organization for an understatement of UBIT relating to a reportable transaction or listed transaction.

Reform certain tax-exempt bonds

The tax reform discussion draft also proposes numerous changes to the treatment of tax-exempt bonds. Changes of particular interest to private tax-exempt organizations are as follows:

- *10% "surtax" on tax-exempt interest*. The new tax rate structure for individuals would impose a 10% "surtax" on interest from tax-exempt bonds for certain "high income" taxpayers (as proposed by section 1001 of the draft legislation).
- *Termination of private activity bonds*. Under the proposed provision (section 3431 of the draft legislation), interest on all private activity bonds issued after December 31, 2014, would be included in gross income and would be subject to tax. Private activity bonds issued on or before December 31, 2014, would not be affected by these changes. State and local governments could continue to issue private activity bonds after 2014, but interest with respect to such bonds would no longer be exempt from tax.
- *Repeal of advance refunding bonds.* A proposed provision (section 3433 of the draft legislation) would subject to tax the interest on all advance refunding bonds. Interest on current refunding bonds would remain tax-exempt. This change would apply to advance refunding bonds issued after December 31, 2014.

Modify certain excise taxes

Modify intermediate sanctions

The discussion draft would expand the applicability of the intermediate sanctions excise tax from section 501(c)(3) public charities, section 501(c)(4), and section 501(c)(29) organizations to also include excess benefit transactions engaged in by section 501(c)(5) labor, agricultural, and horticultural organizations, and section 501(c)(6) business leagues, chambers of commerce, real estate boards, and boards of trade. It would also expand the definition of disqualified persons to include athletic coaches and investment advisors.

The discussion draft also would impose an excise tax of 10% on the tax-exempt organization when an intermediate sanctions excise tax is imposed on the disqualified person. However, the tax would not apply to a transaction when the organization could demonstrate that it met minimum standards of due diligence—i.e., by having the transaction approved in advance by an independent body of the organization that relied on comparability data and documented the basis for approving the transaction.

The provision also would preclude managers from being able to rely on the professional advice safe harbor under the Treasury regulations for purposes of avoiding the manager-level tax.

Modify taxes on self-dealing

Under the discussion draft, private foundations would be subject to a 2.5% (10% for cases involving the payment of compensation) excise tax when the self-dealing tax is imposed on a disqualified person. Also, the provision would preclude managers from being able to rely on the professional advice safe harbor for purposes of avoiding the manager-level tax.

Impose excise tax on failure to distribute, within five years, contribution to donor-advised fund

The discussion draft would require donor-advised funds to distribute contributions to a public charity within five years of receipt. The failure to make such a distribution would subject the sponsoring organization of the donor-advised fund to an annual excise tax equal to 20% of the undistributed funds. For contributions made before, and remaining in the donor-advised fund on, January 1, 2015, the five-year distribution period would begin on January 1, 2015.

Simplify excise tax on private foundation investment income

Under the discussion draft, the excise tax rate on net investment income would be reduced from 2% to 1%. The provision would also repeal the exception from the excise tax for exempt operating foundations.

Repeal exception for private operation foundation failure to distribute income

The discussion draft would repeal the special exclusion from the minimum distribution requirement for private operating foundations. Therefore, private operating foundations generally would be subject to the excise tax for failure to distribute income, like non-operating private foundations.

Impose excise tax on investment income of private colleges and universities

The discussion draft would impose a 1% excise tax on the net investment income of private colleges and universities with non-exempt use assets valued at the close of the preceding year of at least $100,000 per full-time student.

Other general provisions

The discussion draft also proposes other provisions that would affect exempt organizations, related to:

- Repealing the tax-exempt status for professional sports leagues
- Repealing the exemption for certain property and casualty insurance companies and CO-OP health insurance issuers

- Requiring workmen's compensation insurance organizations to provide only insurance coverage required by state law in order to retain exempt status
- Repealing Type II and Type III supporting organizations
- Requiring section 501(c)(4) organizations to provide notice to the IRS of commencement of operations within 60 days of formation
- Expanding declaratory judgment relief to section 501(c)(4) organizations
- Limiting the Form 990, Schedule B (*Schedule of Contributors*) information for section 501(c)(4) organizations to contributions of $5,000 or more from the organization's current or former officers, directors, or five highest compensated employees
- Requiring electronic filing of all Form 990-series forms
- Limiting the IRS and Treasury to the standards and definitions in effect on January 1, 2010 to determine whether an organization is operated exclusively for the promotion of social welfare for purposes of section 501(c)(4)
- For more information, contact a tax professional with the Exempt Organizations group of KPMG's Washington National Tax:

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Individual income tax

General income tax

Tax rates on ordinary income

The discussion draft would significantly alter the current income rate structure under which individuals are taxed.

The current seven-rate structure would be replaced by a structure with three rates: 10%, 25%, and 35%.

The alternative minimum tax (AMT) would be repealed, with the result that income tax liability would be calculated under a single-rate structure.

Although it does not introduce a "flat tax," the discussion draft would produce a significant "flattening" of the current rate structure. For example, a single taxpayer would nominally be subject to tax at the rate of 25% on all taxable income between $35,600 and $400,000. The amount of income subject to tax at 25% would be increased by the phase-out of the lowest 10% rate for higher-income taxpayers, as discussed below.

The discussion draft would also attempt to mitigate (but would not repeal) the impact of the "marriage penalty" that affects some married individuals if both spouses have taxable income. Under current law, an unmarried individual becomes subject to the 28% rate if his or her taxable income exceeds $87,850 (for 2013). However, if that individual is married to someone with a similar amount of income, they would become subject to the 28% rate when their combined income exceeds $146,600—which is less than double the threshold at which the 28% rate applies to unmarried individuals.

Under the proposals in the discussion draft, the marriage penalty would not affect married individuals unless their combined taxable income is in excess of $450,000 (the threshold at which the new highest rate of 35% would become effective for married taxpayers).

The benefit of the 10% rate would be phased out for individuals whose modified adjusted gross income (AGI) exceeds a specified threshold—$300,000 for married taxpayers filing jointly and $250,000 for other individuals. The benefit would be fully phased out when modified AGI reaches $513,600 for joint filers and $356,800 for all other individuals. Thus, higher-income taxpayers would gradually lose the benefit of the lowest tax bracket and most or all of their income would become subject to the 25% bracket.

The term "modified AGI" for this purpose would mean AGI increased by certain specified "tax preference" items, including:

- The standard deduction
- Itemized deductions except the deduction for charitable contributions (which would itself be modified)
- The foreign earned income exclusion under Code section 911 and the exclusions for income from Puerto Rico under section 933 and income from other U.S. possessions under section 931
- Tax-exempt interest, such as interest on municipal bonds
- Excludible employer contributions to employee health insurance plans
- Excludible amounts paid by self-employed individuals for health insurance
- Pre-tax contributions to certain defined contribution retirements plans
- Deductible health savings account (HSA) contributions
- Excludible Social Security benefits and railroad retirement benefits

The same "tax preference" items would be added back to a taxpayer's AGI to establish the modified AGI to which the top tax rate of 35% would apply. In other words, the top rate of 35% would apply to a broader base of income (modified AGI) than would be the

case for the 10% and 25% rates. The 35% rate would therefore function as a type of "surtax" by applying an additional 10% rate over and above the 25% rate on a broader income base.

Although the discussion draft aims at simplification, it is significant that for many wealthier individuals it would no longer be possible to determine tax liability by reference to a single rate table. This is primarily because of the phase-out of the 10% rate and the fact that the tax preference items listed above are subject to the "surtax" described above.

The following somewhat oversimplified example illustrates the application of these rules:

> Assume a single taxpayer has regular AGI of $300,000 and modified AGI of $500,000 (i.e., he has $200,000 of tax preference items such as municipal bond interest and foreign earned income). The $300,000 of regular AGI less any applicable deductions (which are significantly limited by comparison with current law) would initially be subject to tax at the 10% and 25% rates. However, the 10% rate would be fully phased out for this taxpayer given that his modified AGI ($500,000) exceeds $358,600 with the result that the $300,000 would be subject to tax at a flat rate of 25%. In addition, his tax preference items would be subject to the 10% surtax to the extent his modified AGI ($500,000) exceeds the $400,000 threshold applicable to single individuals. Thus, $100,000 would be subject to the 10% surtax.
>
> To further complicate the proposed new rate structure, the discussion draft allows individual taxpayers a deduction in computing adjusted gross income for 40% of their qualified capital gains and dividends; this deduction would apply in computing both the taxable income subject to the 10% and 25% income tax rates, as well as the modified adjusted gross income subject to the 10% surtax. Also, the Discussion Draft would leave in place the current 3.8% tax on net investment income, which has been in effect beginning in 2013 to the extent a taxpayer's modified AGI exceeds $250,000 ($200,000 for single taxpayers) (further adding to this complexity, modified adjusted gross income is defined differently for purposes of the net investment income tax than for purposes of the 10% income tax surtax).

The single taxpayer in this example would thus need to consider numerous factors to determine his marginal tax rate.

Tax rates on capital gains and dividends

The discussion draft would repeal the current system whereby net capital gains and qualified dividends are generally subject to tax at a maximum rate of 20% or 15%, with higher rates for gains from collectibles and unrecaptured depreciation.

Instead, under the discussion draft proposal, individual taxpayers would be entitled to an above-the-line deduction equal to 40% of their "adjusted net capital gain" (defined as the sum of net capital gain and qualified dividends, reduced by net gain from collectibles).

Thus, individuals would generally be subject to tax on only 60% of their net capital gains and qualified dividends, but at the same rates as apply to ordinary income.

Capital gains, dividends, and other investment income would remain subject to the 3.8% net investment income tax.

New inflation adjustments

The discussion draft would introduce a new method for indexing the tax rate thresholds and other amounts for inflation.

Under current law, annual inflation adjustments are made by reference to the consumer price index (CPI). The discussion draft, however, would use "chained CPI," which takes into account consumers' preference for cheaper substitute goods during periods of inflation. (See the footnote on chained CPI in the Accounting section under "Business and industry provisions." Chained CPI would generally result in smaller annual increases to indexed amounts.)

Filing status, standard deductions, and personal exemptions

The discussion draft would simplify taxpayer decisions on filing status by repealing "head of household" status. To compensate for the loss of the increased standard deduction and advantageous tax thresholds available to heads of household under current law, an additional standard deduction would be available for single filers with dependent children (described below).

The discussion draft would significantly increase the standard deduction for all taxpayers. Under current law, married taxpayers filing separately and single taxpayers can claim a standard deduction of $6,100, and married taxpayers filing jointly can claim a standard deduction of $12,200. These amounts would be nearly doubled under the discussion draft to $11,000 and $22,000, respectively.

Single filers with at least one qualifying child would be entitled to an additional standard deduction of $5,500 to compensate for the loss of benefits under the current head of household status. The proposed increase in the standard deduction is intended to significantly reduce the number of taxpayers who itemize their deductions and thus to simplify the tax return preparation process.

The increased standard deduction is also intended to compensate for the loss of the deduction for individual exemptions, which would also be repealed by the discussion

draft. This repeal would apply to the exemptions for the taxpayer, the taxpayer's spouse, and any dependents.

The standard deduction, however, would be subject to phase-out by $20 for each $100 by which modified AGI exceeds $513,600 for joint filers and $356,800 for all other individuals (for 2013). For taxpayers who itemize their deductions, an equivalent amount of itemized deductions would be subject to phase-out. Thus, the benefit of such deductions would be completely phased out at modified AGI of $623,600 for joint filers and $411,800 for all other individuals (for 2013.)

For taxpayers who would still itemize their deductions, the discussion draft would repeal the current 2% floor on miscellaneous itemized deductions and would also repeal the current overall limitation on itemized deductions, whereby the amount of otherwise allowable itemized deductions would be reduced by 3% of the amount by which the taxpayer's adjusted gross income exceeds a threshold amount based on filing status. However, because the discussion draft proposes to repeal many of the itemized deductions available under current law, the attractiveness of itemizing (as opposed to claiming the standard deduction) would be significantly reduced. The proposed repeal of certain itemized deductions is discussed below.

Increase and expand the child tax credit

The discussion draft would increase the amount of the child tax credit from the current law level of $1,000 to $1,500. The discussion draft would also increase the age up to which children could qualify for the credit from 17 years to 18 years. A reduced credit of $500 would be allowed for dependents who are not the children of the taxpayer. In contrast with current law, these amounts would be indexed for inflation, using the chained CPI.

However, the child tax credit would only be allowed for children who are U.S. citizens or nationals. Under current law, the child tax credit is allowed for children who are U.S. residents in addition to those who are U.S. citizens and nationals.

The child tax credit would be refundable to the extent of 25% of the taxpayer's earned income, or earned income in excess of $3,000 for tax years prior to 2018. However, no refundable credit would be available in any tax year in which the taxpayer excludes any amount under Code section 911 (foreign earned income).

The credit would be subject to phase-out for taxpayers whose modified AGI exceeds $627,500 for joint filers or $413,750 for all other individuals (for 2013). These phase-out levels would represent a significant increase in relation to current law, under which the phase-out starts at $110,000 for joint filers and $75,000 for all other individuals.

To claim a refundable credit, the taxpayer would be required to provide his or her own Social Security number on the tax return, but would not be required to provide a Social Security number for the child or dependent.

Modify earned income tax credit

The discussion draft would modify the earned income tax credit (EITC) to provide a refund of Social Security taxes (i.e., FICA taxes) and self-employment tax paid by or with respect to the individual. The employee's share of such taxes would be offset by a credit, whereas the employer's share would be rebated through a refundable tax credit. The maximum amount of the credit would depend on the number of qualifying children the taxpayer has. Taxpayers without at least one qualifying child would not qualify for the credit of the employer's share of the taxes.

Under a special rule for tax years prior to 2018, the credit would be equal to 200% of the taxpayer's Social Security taxes, both the employer and employee portions.

The credit would be subject to phase-out, but at a higher level than under current law.

Repeal certain tax credits for individuals

The discussion draft would repeal the following tax credits available to individuals under current law:

- Dependent care credit
- Credit for adoption expenses
- Credit for non-business energy property
- Credit for residential energy-efficient property
- Credit for qualified electric vehicles
- Alternative motor vehicle credit
- Alternative fuel vehicle refueling property credit
- Credit for new qualified plug-in electric drive motor vehicles

The rationale for repealing the dependent care credit and adoption expenses credit is that these credits, although they provide valuable benefits to families, are overly complex. Also, their repeal would be offset by the increased child tax credit and standard deduction.

Home ownership, financing, and sale

The discussion draft would limit or repeal certain deductions and exclusions available under current law to individual taxpayers who own and mortgage their principal residences.

The discussion draft would modify the current-law provisions that permit individuals to exclude up to $250,000 (or $500,000 for joint filers) of gain from the sale of a principal residence. The discussion draft would increase the required period of ownership from two of the previous five years to five of the previous eight years. In addition, the exclusion would be available only once every five years. The exclusion would be subject to phase-out for individuals whose modified AGI exceeds $250,000 (or $500,000 for joint filers). No phase-out of this exclusion exists under current law.

The discussion draft would limit the deduction available for mortgage interest by gradually reducing the amount of debt that can be treated as acquisition indebtedness from the current level of $1 million to $500,000. This reduction would be phased in over four years after 2014: $875,000 in 2015, $750,000 in 2016, $625,000 in 2017, and $500,000 in 2018.

Debt incurred before 2015 would not be affected by this reduction and would therefore be "grandfathered." Any debt incurred before 2015, but refinanced in 2015 or later, would continue to be covered by current law to the extent the amount of the refinancing does not exceed the amount refinanced. In other words, the amount of debt that qualifies as acquisition indebtedness would not decrease by reason of a refinancing.

The discussion draft would repeal the deduction for interest on home equity indebtedness.

The discussion draft would also repeal the deduction for state and local property taxes unless they are incurred in carrying on a trade or business. Thus, the deduction for property taxes would not be available in relation to a principal residence or vacation home used exclusively by the taxpayer, but would be available for rental property.

Repeal certain itemized deductions and exclusions

In addition to the limitation or repeal of the deductions for mortgage interest, property tax, and charitable contributions, the discussion draft would repeal certain other itemized deductions, including:

- State, local, and foreign income taxes unless incurred in a trade or business or otherwise incurred for the production of income
- Personal casualty losses
- Tax preparation expenses

- Medical expenses
- Alimony payments (these would not be deductible to the payor or includible in the income of the payee)
- Moving expenses
- Contributions to medical savings accounts

Although the discussion draft would repeal the deduction for foreign income taxes, it would not repeal the foreign tax credit rules under which a credit for such taxes can be claimed, subject to limitations. See the Multinational entities section for more details.

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Charitable contribution incentives

The discussion draft would revise the tax treatment of charitable contributions and the related deductions by individual taxpayers.

Charitable contributions

The discussion draft (section 1403 of the draft legislation) would make numerous changes to the rules applicable to charitable contributions—changes that would generally restrict the tax benefit of a contribution made by an individual taxpayer to an exempt organization.

These changes, if enacted, generally would be effective for tax years after 2014:

- *2% floor*. Charitable contributions would be deductible only to the extent they exceed 2% of the individual's AGI.
- *Extend time to make contribution*. Individual taxpayers would be permitted to deduct charitable contributions made after the close of the tax year, but before the due date of their income tax returns (generally, April 15).
- *AGI limitations*. The AGI limitations on deductible contributions would be condensed, and the ability to carry over excess deductions would be repealed:
  - The 50% limitation on cash contributions and 30% limitation on contributions of capital gain property to public charities and certain private foundations would be limited to 40% of AGI. The 30% contribution limit on cash contributions and 20% limitation on contributions of capital gain property that apply to organizations not covered by the current 50% limitation rule would be limited to 25% of AGI.
- *Limit value of deduction generally to adjusted basis*. The amount of any charitable deduction for a contribution of property generally would be limited to the adjusted basis of the contributed property—rather than fair market value. However, for the following types of property, the deduction would be based on the fair market value of the property less any ordinary gain that would have been realized if the property had been sold by the taxpayer at its fair market value: (1) publicly traded stock; (2) tangible property related to the purpose of the donee exempt organization; (3) any qualified conservation contribution; (4) any qualified research property; and (5) any qualified inventory contribution (for inventory contributed solely for the care of the ill, needy, or infants). The proposal would preserve the current-law rule that provides a higher valuation for the charitable deduction.
- *Qualified conservation contributions*. The temporary rules for conservation easements (limiting deductions to 40% of AGI), including the rules for farmers or ranchers (allowing a charitable deduction up to 100% of AGI for property used in agricultural or livestock production), would be made permanent. No deduction would

be permitted for land reasonably expected to be used as a golf course. This portion of the proposed provisions, if enacted, would be effective for tax years after 2013.

- *College athletic event seating right*. A special rule that allows a charitable deduction of 80% of the amount paid for the right to purchase tickets for athletic events would be repealed.
- *Income from intellectual property*. Under the proposal, income from intellectual property contributed to a charitable organization would no longer be allowed as an additional contribution by the donor. The deduction for the contribution of the intellectual property would be retained.

KPMG observation

The discussion draft proposals would increase the standard deduction so that 95% of taxpayers would no longer itemize their deductions. As such, most taxpayers would not realize a "direct" tax deduction for any of their charitable contributions.

For the anticipated 5% of taxpayers who would still itemize their individual income tax returns and claim deductions for their charitable contributions, the deduction would be significantly limited in a number of ways:

- First, the charitable deduction would be subject to a 2% floor so that any contributions that totaled less than 2% of the individual's AGI would not be deductible.
- Second, most transfers of property would be valued at the donor's basis—rather than at the fair market value of the property. Publicly traded stock would be valued at fair market value less any ordinary gain that would have been realized had the stock been sold.
- Finally, if the charitable contribution transfer exceeds the applicable percentage of the individual's AGI, there would appear to be no mechanism for carrying forward any excess amounts as is currently allowed (i.e., for five years).

The discussion draft would put increased pressure on taxpayers to find the "sweet spot" between the minimum and maximum charitable limits in order to realize the tax benefit of their charitable contributions.

Consistent basis reporting between estate and person acquiring property from decedent

The discussion draft (section 1422 of the draft legislation) would require that the value of property as reported for estate tax purposes also be used as its basis for income tax purposes.

The estate would be required to report the value of the property to the IRS and to the beneficiary receiving the property. The provision would be effective for transfers for which an estate tax return is filed after the date of enactment.

A 20% accuracy-related penalty could be imposed on incorrectly reported basis.

Education tax incentives

Consolidate education incentives

Under the discussion draft, all existing higher education tax credits (i.e., the American Opportunity Tax Credit, the Hope Scholarship Credit, and the Lifetime Learning Credit) and a series of other educational tax incentives would be repealed and generally replaced with one permanent credit in the form of a modified American Opportunity Tax Credit (AOTC).

The proposed AOTC would:

- Continue to provide for a 100% tax credit for the first $2,000 in qualifying higher education expenses, and a 25% tax credit for the next $2,000 of such expenses
- Continue to be available for up to four years of higher education
- Continue to define eligible expenses to include tuition, fees, and course materials

However, the modified AOTC would make a larger amount of the credit refundable (i.e., $1,500 as compared to the current amount of $1,000).

Also, the new AOTC would phase out at lower rates for modified AGI—between $86,000 and $126,000 for joint filers and $43,000 and $63,000 for other filers (current version is phased out between $160,000 and $180,000 for joint filers and $80,000 and $90,000 for other filers). These phase-outs would be indexed for inflation, starting in 2018.

In implementing this single educational credit, the following current educational incentives are proposed to be repealed:

- Exclusion of income from U.S. savings bonds used to pay higher education and fees (Code section 1203)
- Deduction for interest on educational loans (section 1204)

- Deduction for qualified tuition and related expenses (section 1205)
- New contributions to Coverdell education savings accounts (section 1206)
- Exclusion for discharge of student loan indebtedness (section 1207)
- Exclusion for qualified tuition reductions (section 1208)
- Exclusion for education existence programs (section 1209)
- Exception to 10% penalty for distributions from retirement plans used to pay for higher-education expenses (section 1210)

KPMG observation

Because the discussion draft proposes to repeal and eliminate currently available educational incentives in favor of just one tax credit (albeit one of the more beneficial credits), many individuals now eligible for education-related tax incentives would no longer receive any benefit for their previously qualifying expenditures.

For example, the proposed revised version of the AOTC would have a significantly reduced AGI phase-out, which would prevent many individuals from benefiting from this new credit. In addition, the AOTC would be limited to the first four years of post-secondary education. Therefore, many individuals who were benefiting from certain incentives for post-graduate studies (such as through the Lifetime Learning Credit or the tuition deduction) would no longer be able to benefit.

Further, individuals who are no longer incurring costs for qualifying education but still have significant student loan debt would no longer receive any benefit for interest payments made on those loans.

Expand Pell Grant exclusion from gross income

Under current law, qualified scholarship amounts (such as Pell Grants) received by a degree candidate at a qualifying educational organization are generally excluded from gross income only if such funds are used for qualified tuition and related expenses (but not room and board). Under the provisions of the discussion draft, all Pell Grant amounts would be excluded from income regardless of how they might be used.

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Appendix

Camp's Plan for Carried Interest

House Ways and Means Committee Chairman Dave Camp (R-MI) yesterday released draft legislation ("Discussion Draft") that would change the taxation of carried interest. This article discusses how the proposal differs from previous proposals and examines the proposed model for calculating taxable income to certain service partners in the investment fund industry.

Thursday, February 27, 2014

by James B. Sowell,
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Chairman Camp yesterday released the Discussion Draft of his proposed legislation addressing tax reform. The proposed legislation contains a proposal to address the taxation of carried interest.

Before getting in to the technical discussion of the Discussion Draft, it is useful to highlight the radically different approach that is taken under his proposal in attempting to isolate what the tax writers view as the service component of the partnership income.

A New Model

Previous proposals were based upon the model originally proposed by Rep. Sander Levin in 2007. Those proposals essentially presumed that all income allocated to a partner providing specified services to an investment partnership would be taxed at ordinary income rates, except to the extent the partner could prove, under a narrow rule relating to qualified capital, that a portion of the partner's return was attributable to invested capital. In other words, any income allocated to a service partner that could not be properly traced to a qualified capital interest was presumed to be properly attributable to services and hence taxable at ordinary income rates.

Although not explicitly stated, the carried interest proposal set forth in the Discussion Draft appears to follow a model suggested by certain commentators whereby the general partner ("GP") is presumed to borrow from the other partners an amount equal to the partnership capital that is used to fund the GP's share of profit. Because no interest is charged on the borrowed capital, interest is effectively imputed to the GP on the amount deemed borrowed. The imputed interest is reserved as a potential

amount attributable to services provided by the GP. Under the Discussion Draft proposal, the imputed interest is used to establish a "recharacterization account balance," and partnership income allocated to the GP is treated as ordinary income to the extent of the "recharacterization account balance." An analogous approach has been proposed in certain articles, including the following: Fleischer, *Two and Twenty: Taxing Partnership Profit in Private Equity Funds*, 83 N.Y.U. L. Rev. 1 (2008), and Cunningham and Engler, *The Carried Interest Controversy: Let's Not Get Carried Away*, 61 Tax L. Rev. 121 (2008).

As a very simplistic example, if the GP is entitled to 20 percent of partnership income, the GP effectively would be treated as borrowing an amount equal to 20 percent of the partnership invested capital and contributing such capital to the partnership. A stated interest rate would be imputed based upon the borrowed capital, and the interest that is deemed accrued would establish the amount of partnership income allocated to the GP that may be treated as ordinary.

While simple in concept, the rules attempting to carry out this model are very complicated. And the Discussion Draft may arguably overstate significantly the amount that might be properly attributed to services under a more precise interest imputation model that is tailored to the specific economic arrangement.

Technical Rules

Who Is Covered?

The proposed rules would apply to an "applicable partnership interest." An "applicable partnership interest" is any interest in a partnership which, directly or indirectly, is transferred to (or is held by) the taxpayer in connection with the performance of services by the taxpayer, or any other person, in any applicable trade or business. An applicable trade or business involves a trade or business that consists, in whole or in part, of the following activities: (1) raising or returning capital; (2) investing in (or disposing of) trades or businesses (or identifying trades or businesses for such investing or disposition); and (3) developing such trades or business. The proposed statute makes clear that an activity involving research and experimentation is covered, apparently indicating that venture capital funds are subject to the legislation. By contrast, the Section-By-Section

Summary released in connection with the legislation states that "*[t]he provision would not apply to a partnership engaged in a real property trade or business*." (Emphasis added.) There is no indication as to the definition of a real property trade or business (e.g., is a hotel part of a real property trade or business?) and how one should treat an interest in a partnership that has real property and other trade or business activities. Interestingly, neither the proposed statute nor the Joint Committee explanation explicitly references the exclusion for real estate.

How Are Covered Parties Taxed?

If a partner holds an "applicable partnership interest," any net capital gain allocated to the partner up to the amount of the partner's "recharacterization account balance" would be treated as ordinary income. The provision also seems to set up a potential for character mismatches depending on the timing of gain and loss inclusions. Specifically, no provision is made for the treatment of allocated losses. Thus, for example, it appears that to the extent capital losses are allocated to charge back amounts that previously were recharacterized as ordinary income, such losses would continue to be treated as capital.

Under the proposal, the "recharacterization account balance" for a taxable year is equal to the partner's current-year "annual recharacterization amount" plus the recharacterization account balance carried forward from the prior year over net ordinary income allocated with respect to the interest for the current year plus the amount recharacterized as ordinary income under the proposal in the preceding year. Note that, under this rule, the recharacterization account balance does not necessarily measure the amount of capital gain that will be recharacterized, as amounts that are treated as ordinary income without regard to the legislation also will apply in reduction of the recharacterization account balance.

The "annual recharacterization amount" means an amount equal to the product of:

> (1) The long-term applicable federal rate as determined under section 1274(d)(1) for the relevant year (currently 3.36 percent), plus 10 percentage points (i.e., the "specified rate"), and
>
> (2) (a) The highest percentage profits that could be allocated to a partner for the taxable year (assuming facts and circumstances

Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

> with respect to such taxable year as would result in such highest percentage) multiplied by the partnership's aggregate invested capital, reduced by (b) the "specified capital contribution" of the partner holding the applicable partnership interest for such taxable year.

An example is helpful in illustrating how the "annual recharacterization amount" incorporates the deemed loan model.

> Assume a partnership with a distribution waterfall that allocates cash flow in the following priority: (1) return investor capital to investors, (2) 8 percent internal rate of return ("IRR") to investors, and (3) share 80-20 between investors and GP. Also assume that the total contributed capital for the partnership is $1 billion, and the GP has contributed no capital (and thus has no "specified capital contribution" that might partially offset the aggregate invested capital). Because the highest possible share of profits for the GP is equal to 20 percent and the GP invested no capital itself, the GP's "recharacterization account balance" that frames the potential ordinary income inclusion related to that year would equal 13.36 percent multiplied by $200 million ($1 billion x .20), or $26,720,000. Note that the GP is effectively imputed interest at a high rate of 13.36 percent on a deemed $200 million loan that it uses to acquire a pro rata capital interest on which it forgoes an 8 percent IRR prior to participating in any return.

Obviously, this is not an economic arrangement that many astute business people would negotiate.

Note that, if the GP had itself made a "specified capital contribution," that amount would have reduced the $200 million aggregate invested capital to which the 13.36-percentage rate is applied. However, the full amount of net capital gain, including the net capital gain attributable to the "specified capital contribution," would be subject to recharacterization as ordinary income up to the "recharacterization account balance." Accordingly, there is a very good chance that income attributable to invested capital would be recharacterized as ordinary income under the proposal.

In addition, imagine how high the "recharacterization account balance" could climb in an arrangement in which the GP negotiates a staged carry that may reach as high as 50 percent after a very high IRR such as 30

percent. Because the imputed capital loan is determined by reference to the highest share of profit, the "recharacterization account balance" could be determined by reference to a deemed share of capital represented by a percentage of profits that nobody ever expects the GP to achieve.

It should be noted that the proposed statute does provide Treasury with authority to "prescribe rules for the determination of the applicable percentage in cases in which the percentage of profits . . . that are allocated with respect to an applicable partnership interest varies on the basis of the aggregate amount of such profits." In this situation, the guidance may provide a percentage that would be used in lieu of the highest percentage determined as referenced above when the other percentage is consistent with the purposes of the provision.

As with prior bills addressing carried interest, there are rules addressing the treatment of certain loaned amounts in determining the amount that should be subject to ordinary income treatment. In the context of the Discussion Draft proposal, amounts loaned to the partnership by a partner are treated as invested capital for purposes of applying the applicable percentage (i.e., highest share of profits) under the calculation described above as are third party loans that are convertible into equity or that have other equity participation features. In addition, in determining the "specified capital contribution" credited to the holder of an applicable partnership interest" (which amount may offset the aggregate invested capital under the formula), amounts funded with loans from the partnership, other partners, or persons related to the other partners will not be counted.

Also, it is significant that the calculation of the "specified capital contribution" for a partner who holds an "applicable partnership interest" is different from the determination of aggregate invested capital for all partners. Specifically, the "specified capital contribution" of the "applicable partnership interest" holder is reduced by all distributions, while the aggregate invested capital for all partners is reduced only by liquidating distributions. The disparate treatment obviously is disadvantageous to the holder of the "applicable partnership interest" since that partner's share of the "specified capital contribution" that offsets the total invested capital will be reduced more quickly than total invested capital is reduced.

Other Implications

In addition to the recharacterization of allocated income, under the Discussion Draft, any gain on the disposition of an "applicable partnership interest" will be recognized without regard to nonrecognition provisions (such as sections 351, 721, etc.) that might otherwise apply, and such gain will be taxed at ordinary income rates to the extent of the "recharacterization account balance" related to the interest.

The proposed statute also includes a rule that would cause a taxpayer to include in gross income its "recharacterization account balance" (to the extent attributable to the transferred interest) upon a transfer to a family member (as defined under section 318(a)(1)) or a person who performed services within the current calendar year or the preceding three calendar years in any applicable trade or business in which the taxpayer performed a service. Note that this rule forces recognition of the "recharacterization account balance" regardless of whether there is any gain attributable to the interest.

If the holder of an "applicable partnership interest" receives a distribution of property, the partner will recognize gain equal to the excess of (1) the fair market value of the property at the time of the distribution, over (2) the adjusted basis of such property in the hands of the partner (i.e., the carry over basis in the hands of the partner, limited by reference to the partner's basis in its partnership interest). Again, such gain would be taxed at ordinary income rates to the extent of the "recharacterization account balance" related to the interest.

Effective Date

The Discussion Draft, if enacted, would be effective for taxable years beginning after December 31, 2014.

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