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# General Explanations of the Administration's Fiscal Year 2025 Revenue Proposals

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## NOTES

The revenue proposals are estimated relative to a baseline of current law.

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

Within the *General Explanations of the Administration's Fiscal Year 2025 Revenue Proposals*, unless otherwise stated:

- “AGI” refers to Adjusted Gross Income.
- “Budget” refers to the *Fiscal Year 2025 Budget of the U.S. Government*.
- “Code” refers to the Internal Revenue Code.
- “C-CPI-U” refers to the Chained Consumer Price Index for Urban Consumers.
- “IRS” refers to the Internal Revenue Service.
- “OECD” refers to the Organisation for Economic Co-operation and Development.
- “Section” refers to the respective section of the Internal Revenue Code.
- “Secretary” refers to the Secretary of the Treasury and/or her delegates.
- “Secretary of the Treasury” refers to the Secretary of the Treasury personally and does not include her delegates.
- “Treasury” refers to the U.S. Department of the Treasury.
- “TIN” refers to Taxpayer Identification Number.



## **REVENUE PROPOSALS**

In the Fiscal Year 2025 Budget, the President proposes a series of reforms that would raise revenues, expand tax credits for workers and families, and improve tax administration and compliance. These reforms cover all areas of tax policy and together they result in a tax system that is both more equitable and more efficient.

For example, reforms to business and international taxation would raise the corporate tax rate and the corporate alternative minimum tax rate, increase the excise tax rate on stock buybacks, end corporate tax deductions for employee compensation over \$1 million, and close several business tax loopholes. Additional reforms would strengthen the taxation of foreign earnings and reduce tax incentives that encourage profit shifting and offshoring, consistent with the historic international agreement to implement a global minimum tax and modernize the individual tax system. This agreement will help end the race to the bottom in corporate tax rates and level the playing field for U.S. businesses while protecting U.S. workers. This agreement also updates our international tax rules to provide stability and certainty. Countries around the world are enacting legislation to implement the global minimum tax.

Similarly, reforms to the taxation of high-income taxpayers would raise additional revenue and help ensure more equal treatment of labor and capital income. Income tax rates for those with the highest incomes would increase. Capital gains and dividends would generally be taxed at ordinary rates for those with high incomes, and a loophole that lets some capital gains income escape income taxation forever would be eliminated for certain wealthy taxpayers. A new 25-percent minimum income tax would be imposed on extremely wealthy taxpayers. For high-income taxpayers, gaps in the law that allow some pass-through business owners to avoid Medicare taxes would be eliminated and Medicare tax rates would be increased. Additional loopholes, including the carried interest preference and the like-kind exchange real estate preference, would be eliminated for those with the highest incomes. Together these reforms would sharply curtail tax preferences that allow the wealthy to pay lower tax rates on their investment income and exacerbate income and wealth disparities, including by gender, geography, race, and ethnicity.

Finally, the Budget would expand tax credits for workers and families, reducing child poverty and expanding opportunity. The child tax credit would be expanded through 2025, would permanently be made fully refundable, determined monthly, and paid out in advance. Reforms to the delivery of the credit would facilitate take-up. The earned income tax credit would also be expanded to cover more workers without children. The premium tax credit expansion first enacted in the American Rescue Plan Act of 2021 and extended in the Inflation Reduction Act of 2022 would be made permanent, making health insurance more affordable for millions of families.

Additional reforms would support housing and urban development, eliminate fossil fuel tax preferences, close estate and gift tax loopholes, and improve tax administration and compliance.

## **REFORM BUSINESS TAXATION**

### **RAISE THE CORPORATE INCOME TAX RATE TO 28 PERCENT**

#### **Current Law**

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

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

#### **Reasons for Change**

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

#### **Proposal**

The proposal would increase the tax rate for C corporations from 21 percent to 28 percent. The effective global intangible low-taxed income (GILTI) rate would increase to 14 percent under the proposal. The proposal [\*Revise the Global Minimum Tax Regime, Limit Inversions, and Make Related Reforms\*](#) described later in this text would further increase the effective GILTI rate to 21 percent.

The proposal would be effective for taxable years beginning after December 31, 2023. For taxable years beginning before January 1, 2024, and ending after December 31, 2023, the corporate income tax rate would be equal to 21 percent plus 7 percent times the portion of the taxable year that occurs in 2024.

## **INCREASE THE CORPORATE ALTERNATIVE MINIMUM TAX (CAMT) RATE TO 21 PERCENT**

### **Current Law**

For taxable years beginning after December 31, 2022, section 55(a) of the Internal Revenue Code imposes an alternative minimum tax on certain corporations based on their adjusted financial statement income (AFSI). This tax is commonly referred to as the Corporate AMT or CAMT.

The CAMT applies to corporations (other than S corporations, regulated investment companies, or real estate investment trusts) that meet an average AFSI test that in general terms is met when average AFSI (with certain modifications) for a 3-taxable-year period exceeds \$1 billion, with certain special rules for foreign-parented groups.

The CAMT is equal to the excess (if any) of (a) the tentative minimum tax for the taxable year, over (b) the sum of the regular income tax imposed for the taxable year (reduced by the foreign tax credit, but no other credits) plus the tax imposed under the base erosion and anti-abuse tax (BEAT) for such taxable year.

The tentative minimum tax for the taxable year is equal to the excess of (a) 15 percent of the corporation's AFSI for the taxable year, over (b) a special CAMT foreign tax credit. A corporation's AFSI for a taxable year is equal to the net income or loss set forth on the taxpayer's applicable financial statement with certain adjustments. An applicable financial statement is generally an audited financial statement issued to shareholders and/or creditors.

To the extent an applicable corporation incurs a CAMT liability for a taxable year, the CAMT liability gives rise to a CAMT credit that can be carried forward to offset the corporation's regular tax liability in future years (subject to certain limitations).

### **Reasons for Change**

The CAMT works to reduce the significant disparity between the income reported by large corporations on their Federal income tax returns and the profits reported to shareholders in financial statements by requiring them to pay a minimum amount of tax based on their reported financial statement income. The proposal strengthens the CAMT by increasing the CAMT rate roughly in line with the proposed increase in the regular corporate tax rate and aligns the CAMT rate with the proposed effective GILTI rate. The proposal is a targeted approach to ensure that the most aggressive corporate tax avoiders bear meaningful Federal income tax liabilities.

### **Proposal**

The proposal would increase the rate used to compute the tentative minimum tax from 15 percent to 21 percent.

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

## **INCREASE THE EXCISE TAX RATE ON REPURCHASE OF CORPORATE STOCK AND CLOSE LOOPHOLES**

### **Current Law**

The stock repurchase excise tax applies at a rate of one percent of the fair market value (FMV) of any stock of a covered corporation that is repurchased by the corporation during its taxable year. The statute generally defines a “covered corporation” as a domestic corporation whose stock is publicly traded on an established securities market. An established securities market for this purpose includes U.S. national securities exchanges, certain foreign securities exchanges, regional or local exchanges, and certain interdealer quotation systems. “Repurchases” include a corporation’s acquisition of any of its stock from a shareholder for property that qualifies as a redemption of the stock as defined in the Internal Revenue Code (Code). The statute also provides that a repurchase includes any other transaction that the Secretary determines in regulations or other guidance to be “economically similar” to a redemption of stock. A repurchase also may include acquisitions of the corporation’s stock by certain specified affiliates.

The stock repurchase excise tax applies to the acquisition of stock of a foreign corporation, the stock of which is traded on an established securities market (an “applicable foreign corporation”) by a specified affiliate of such corporation. In this case, the stock repurchase excise tax only applies to the extent the specified affiliate is not a foreign corporation or a foreign partnership (unless such partnership has a domestic entity as a direct or indirect partner). The excise tax also applies to the acquisition of stock of certain foreign corporations subject to the inversion rules.

The annual FMV of a covered corporation’s repurchased stock is reduced by certain exceptions and reductions, including the FMV of the covered corporation’s stock that is issued or provided to employees during the taxable year.

### **Reasons for Change**

Stock repurchases are tax-favored relative to dividends as a means of distributing corporate profits to shareholders. Increasing the excise tax rate on stock repurchases would reduce this disparity. Moreover, raising the tax rate is an administratively simple and progressive way to raise revenue to pay for the Administration’s fiscal priorities. In addition, the tax should apply to specified affiliates of an applicable foreign corporation that are controlled foreign corporations (CFCs), generally corporations whose stock is majority owned by U.S. shareholders (taking into account stock attribution rules), in the same manner that it applies to specified affiliates of an applicable foreign corporation that are U.S. corporations.

### **Proposal**

The proposal would increase the tax rate on corporate stock repurchases to 4 percent. The proposal also would extend the stock repurchase excise tax to the acquisition of stock of an

applicable foreign corporation by a specified affiliate of the applicable foreign corporation that is a CFC.

The proposal would apply to repurchases of stock after December 31, 2023.

## TAX CORPORATE DISTRIBUTIONS AS DIVIDENDS

### Current Law

Section 301 of the Internal Revenue Code (Code) provides rules for characterizing a distribution of property by a corporation to a shareholder. The amount of the distribution is first treated as a dividend under section 301(c)(1) to the extent of the distributing corporation's applicable earnings and profits. Outside of corporate reorganization and spin-off contexts, section 316 provides that all of a corporation's current and accumulated earnings and profits are taken into account in determining the extent to which a distribution of property made by the corporation is taxed as a dividend. The amount of the corporation's earnings and profits at the time the distribution is made is not controlling. Rather, earnings and profits of a corporation are generally computed on a standalone basis as of the close of the corporation's taxable year in which the distribution is made without diminution as a result of distributions made during the taxable year. Special rules apply for consolidated groups, and in the case of a deemed dividend resulting from a sale of stock of a controlled foreign corporation (CFC), as defined in section 957.

The portion of the distribution received by the shareholder that is not a dividend is applied against and reduces the shareholder's adjusted basis of the corporation's stock under section 301(c)(2), and any amount distributed in excess of the shareholder's basis that is not a dividend is treated as gain from the sale or exchange of property under section 301(c)(3). The shareholder takes a basis in the distributed property equal to its fair market value under section 301(d).

Generally, the corporation is required to recognize under section 311(b) any gain realized on the distribution of any appreciated property to a shareholder (and its earnings and profits are increased by such gain under section 312) but does not recognize under section 311(a) any loss realized on a distribution of property with respect to its stock. Although the corporation does not recognize a loss, its earnings and profits are decreased under section 312 by the sum of the amount of money, the principal amount or issue price of any obligations (as the case may be), and the adjusted basis of any other property, so distributed.

If an actual or deemed redemption of stock is treated under section 302 as equivalent to the receipt of a dividend by a shareholder, the shareholder's basis in any remaining stock of the corporation is increased by the shareholder's basis in the redeemed stock. In addition, if a subsidiary corporation acquires in exchange for cash or other property stock of a direct or indirect corporate shareholder issued by that corporation (often referred to as "hook stock"), the issuing corporation does not recognize gain or loss (or any income) under section 1032 upon the receipt of the subsidiary's cash or other property in exchange for issuing the hook stock.

If, as part of a corporate reorganization, a shareholder receives in exchange for stock of the target corporation both stock and property not permitted to be received without the recognition of gain (often referred to as "boot"), the exchanging shareholder is required to recognize under section 356(a)(1) gain equal to the lesser of the gain realized in the exchange or the amount of boot received (commonly referred to as the "boot-within-gain" limitation). If the exchange has the effect of the distribution of a dividend, then section 356(a)(2) provides that all or part of the gain recognized by the exchanging shareholder is treated as a dividend to the extent of the

shareholder's ratable share of the corporation's earnings and profits. The remainder of the gain (if any) is treated as gain from the exchange of property.

### **Reasons for Change**

Corporations have devised many ways to avoid dividend treatment under current law. For example, corporations can enter into preparatory transactions to eliminate a corporation's earnings and profits or shift the corporation's earnings and profits to a prior or subsequent tax year. Corporations also enter into transactions (so-called "leveraged distributions") to avoid dividend treatment upon a distribution by having a corporation with earnings and profits provide funds (for example, through a loan) to a related corporation with no or little earnings and profits, but in which the distributee shareholder has high stock basis. In addition, because current law permits a corporation to receive cash without recognizing any income in exchange for issuing its stock, subsidiaries may distribute property tax-free to corporate shareholders in exchange for stock issued by such shareholder.

Under current law, these types of transactions reduce earnings and profits for the year in which a distribution is made without a commensurate reduction in a corporation's dividend paying capacity. Such transactions are inconsistent with a corporate tax regime in which earnings and profits are viewed as measuring a corporation's dividend-paying capacity, and these transactions inappropriately result in the avoidance of dividend treatment for the corporation's shareholders. Finally, there is not a significant policy reason to vary the tax treatment of a distribution received in a reorganization (and currently subject to the boot-within-gain limitation of section 356) with the treatment afforded ordinary distributions under section 301.

### **Proposal**

The proposal would amend the Code to ensure that a transfer of property by a corporation to its shareholder(s) better reflects the corporation's dividend-paying capacity in the following ways:

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

The proposal would amend section 312(a)(3) to provide that earnings and profits are reduced by the basis in any distributed high-basis stock determined without regard to basis adjustments resulting from actual or deemed dividend equivalent redemptions or any series of distributions or transactions undertaken with a view to create and distribute high-basis stock of any corporation.

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

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

The proposal would treat a leveraged distribution from a corporation (distributing corporation) to its shareholder(s) that is treated as a recovery of basis as the receipt of a dividend directly from a related corporation (funding corporation) to the extent the funding corporation funded the

distribution with a principal purpose of not treating the distribution as a dividend from the funding corporation.

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

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

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

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

Repeal gain limitation for dividends received in reorganization exchanges

The proposal would repeal the boot-within-gain limitation in reorganization transactions in which the shareholder's exchange is treated under section 356(a)(2) as having the effect of the distribution of a dividend. For this purpose, the Administration also proposes to align the available pool of earnings and profits to test for dividend treatment with the rules of section 316 governing ordinary distributions.

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

## LIMIT TAX AVOIDANCE THROUGH INAPPROPRIATE LEVERAGING OF PARTIES TO DIVISIVE REORGANIZATIONS

### Current Law

In general, when a corporation distributes appreciated property to its shareholders, the corporation must recognize gain on the built-in appreciation (that is, the value of that property less the corporation's adjusted basis in that property). Sections 355 and 368(a)(1)(D) of the Internal Revenue Code (Code) provide an exception to this general gain recognition rule in the case of divisive reorganizations, commonly referred to as "spin-offs", "split-offs", or "split-ups".

In a divisive reorganization, a parent corporation (Distributing) transfers property (for example, the appreciated assets underlying a line of business) to a corporation it controls (Controlled), in exchange for consideration. In the simplest version of a divisive reorganization, the consideration Distributing receives consists solely of Controlled stock, which Distributing then must distribute to its shareholders. In this case, none of Distributing, Controlled, or their shareholders will recognize any gain, despite Distributing effectively transferring the built-in gain underlying the Controlled stock (related to the appreciated assets transferred to Controlled by Distributing) to Distributing's shareholders.

Commonly, divisive reorganizations are structured such that Distributing receives more than Controlled stock. This consideration may include (a) securities or other debt obligations of which Controlled is the obligor (Controlled debt), (b) money and other property other than Controlled debt (Controlled boot), and (c) the assumption by Controlled of Distributing's liabilities (Controlled liability assumption). Distributing can transfer Controlled boot and debt to its creditors without recognition of gain. This is known as "monetization".

This monetization may require Distributing to recognize gain. For instance, Distributing recognizes gain on any boot or Controlled debt that it retains. However, current law provides for two safe harbors that allow some monetization to occur without Distributing recognizing gain. The first safe harbor provides that Distributing does not recognize gain if the amount of the assumed Controlled liabilities and any Controlled boot transferred to Distributing's creditors does not exceed the aggregate adjusted basis of the assets that Distributing transfers to Controlled (adjusted basis limitation). The second safe harbor provides that an unlimited amount of Controlled debt securities may be transferred to Distributing's creditors without gain recognition.

In addition, certain other liabilities assumed by Controlled under current law are not subject to the adjusted basis limitation due to their contingent or speculative nature (contingent Distributing liabilities). Once fixed and determinable at a later date, these liabilities often are very large, and typically far exceed their estimated amounts. As a result, Distributing can cause Controlled to make payments to satisfy contingent Distributing liabilities arising from assets and businesses contributed to Controlled for an unlimited future period and in an unlimited aggregate amount.

For the transaction to qualify for non-recognition treatment, the Code requires that Distributing and Controlled be engaged immediately after the distribution in the active conduct of a trade or

business. However, currently there are no adequate safeguards to ensure Controlled’s adequate capitalization or continued economic viability following its separation from Distributing through a divisive reorganization.

### **Reasons for Change**

The Distributing monetization techniques carried out in divisive reorganizations are all economically similar, and therefore should be subject to the same adjusted basis limitation. In the absence of a comprehensive limitation, divisive reorganizations can provide opportunities for tax-planners to structure transactions that economically resemble tax-free cash sales.<sup>1</sup>

Moreover, as described above, Distributing can effectively circumvent the adjusted basis limit by transferring contingent liabilities to Controlled, which similarly allows Distributing to accomplish transactions that resemble tax-free cash sales. Additionally, this practice can burden Controlled with crippling liabilities and excessive leverage, jeopardizing its ability to continue as a viable going concern. Such practice is inconsistent with the intent and purposes of the divisive reorganization provisions of the Code,<sup>2</sup> and has resulted in numerous Controlled bankruptcies.

Taken together, the proposal’s elimination of these monetization loopholes will increase the integrity of the Code.

### **Proposal**

#### **Eliminate excessive tax-free monetization of divisive reorganizations**

The proposal would modify the two safe harbors for the tax-free transfer of Controlled boot and securities to Distributing creditors. In particular, the proposal would define a new quantity, the “excess monetization amount,” equal to the aggregate of the following amounts less the total adjusted bases of the assets transferred by Distributing to Controlled: (a) the total amount of the liabilities assumed by Controlled, (b) the total amount of Controlled boot transferred to Distributing’s creditors, (c) the fair market value of nonqualified preferred stock transferred to Distributing’s creditors, and (d) the total principal amount of Controlled debt transferred to Distributing’s creditors.

The proposal would not limit the amount of stock (or right to acquire stock) in Distributing or Controlled received as part of the transaction, which the statute treats as property qualifying for nonrecognition treatment. This exception reflects the fact that such qualifying property does not give rise to the same tax-free monetization concerns that are posed by Controlled debt, which more closely resembles cash than an equity interest.

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<sup>1</sup> This proposal would eliminate those opportunities by extending Congress’ prior amendments to section 361 that eliminated unlimited nonrecognition treatment for Controlled boot transferred to Distributing’s creditors. H.R. Conf. Rep. 108-755 (Oct. 7, 2004), at 770 (observing that the amount of property that may be distributed to creditors without gain recognition is unlimited under then-present law).

<sup>2</sup> *Gregory v. Helvering*, 293 U.S. 465, 469 (1935) (“But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended.”); S. Rep. No. 82-781, at 58 (1951) (emphasizing that “all of the new corporations as well as the parent [must] carry on a business”).

Under the proposal, an excess monetization amount would cause Distributing to recognize gain in two ways. First, Distributing would recognize gain dollar-for-dollar equal to the smaller of Distributing's excess monetization amount or the amount of Controlled boot that Distributing transfers to its creditors. Therefore, if Distributing's excess monetization amount equaled \$3 billion and Distributing transferred \$4 billion of Controlled boot to its creditors, Distributing would recognize \$3 billion of gain.

Second, Distributing would recognize gain if Distributing's excess monetization amount exceeds the amount of Controlled boot that Distributing transfers to Distributing's creditors. Specifically, this remaining excess monetization amount would cause an equal principal amount of Controlled debt to be treated as if sold in a taxable sale. Therefore, if Distributing's excess monetization amount equaled \$5 billion, and Distributing transferred \$4 billion of Controlled boot and \$1 billion of Controlled debt to Distributing's creditors, Distributing would recognize gain to the extent that \$1 billion exceeds the adjusted basis of that Controlled debt. This would be in addition to the \$4 billion in dollar-for-dollar gain on the Controlled boot transferred to Distributing's creditors.

#### Prevent tax avoidance through the transfer of contingent liabilities to Controlled

The proposal would impose two additional requirements under section 355 that, if not satisfied, would result in gain recognition by Distributing (but not Distributing's shareholders). First, under the proposal, Controlled must be adequately capitalized as a result of the divisive reorganization. Second, Controlled must continue to be an economically viable entity after the completion of the divisive reorganization. The satisfaction of both of these requirements would be based on all relevant facts and circumstances,<sup>3</sup> including (a) the projected, as well as actual, amount of contingent Distributing liabilities assumed by Controlled, and (b) whether Controlled declares bankruptcy within the five-year period following the divisive reorganization. In addition, the proposal would authorize the Secretary to promulgate such regulations as may be necessary to carry out the purposes of the proposal or to prevent the avoidance of tax.

Both parts of the proposal would be effective for transactions occurring after enactment. However, the new rules would not apply to any distribution pursuant to a divisive reorganization described in a ruling request initially submitted to the Internal Revenue Service on or before the date of enactment (if the request has not been withdrawn and for which a ruling has not been issued or denied in its entirety as of such date).

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<sup>3</sup> For purposes of this analysis, the fact that one or more creditors would lend to Controlled would not be relevant.

## LIMIT LOSSES RECOGNIZED IN LIQUIDATION TRANSACTIONS

### Current Law

In general, if a corporation distributes its property in complete liquidation, the shareholders of the corporation recognize gain or loss on their stock under section 331 of the Internal Revenue Code, and the corporation recognizes gain or loss on the property distributed to the shareholders under section 336. Under section 332, however, if the same corporate shareholder owns 80 percent or more (by vote and value) of the distributing corporation's stock, then the 80 percent corporate shareholder does not recognize gain or loss on the liquidation and, under section 337, the liquidating corporation does not recognize gain or loss on property distributed to the 80 percent shareholder. Related party stock ownership is not taken into account for purposes of determining whether the 80 percent threshold is satisfied, unless the shareholders are members of a single U.S. consolidated group.

Section 267(a) disallows losses recognized on sales or exchanges of property between related parties. However, losses recognized on the sale or exchange of property between members of a controlled group of corporations, are generally deferred under section 267(f)(2) until the property is transferred outside the controlled group. For this purpose, a controlled group of corporations is defined using a 50 percent ownership threshold under sections 267(f)(1) and 1563(a). Section 267 does not apply to losses incurred on the complete liquidation of a corporation.

### Reasons for Change

Taxpayers with a built-in loss in the stock of a subsidiary may be able to recognize the loss on a taxable liquidation within a controlled group of corporations under section 331, without exiting their investment. For example, a corporate taxpayer may transfer more than 20 percent of the stock of the subsidiary to a related entity, reducing ownership below the 80 percent threshold, and then cause the subsidiary to liquidate.<sup>4</sup> The liquidation is often accomplished through a “check-the-box” election to be classified as a partnership rather than a corporation, an election which applies only for U.S. income tax purposes. Structuring into such taxable liquidations can also be used to recognize a loss on property held by the liquidating corporation under section 336, such as in cases involving a foreign-owned domestic corporation.

### Proposal

Section 267 would be modified to apply to complete liquidations within a controlled group where the assets of the liquidating corporation remain in the controlled group after the liquidation. Where applicable, this would cause losses – both on the stock of the liquidating corporation and the property it holds – to be denied. The proposal would also grant the Secretary the authority to allow for the deferral, rather than the denial, of such losses under the principles of section 267(f), as well to address the use of controlled partnerships to avoid these rules.

The proposal would apply to distributions after the date of enactment.

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<sup>4</sup> Granite Trust Co. v. United States, 238 F.2d 670 (1st Cir. 1956).

## **PREVENT BASIS SHIFTING BY RELATED PARTIES THROUGH PARTNERSHIPS**

### **Current Law**

A partnership is permitted to make a section 754 election to adjust the basis of its property when it makes certain distributions of money or property to a partner. For example, if a partnership distributes property to a partner and the partnership has a section 754 election in effect, the partnership may increase (“step-up”) the basis of its non-distributed property. If there is no gain recognized by the distributee-partner as a result of the distribution, the partnership step-up is generally equal to the excess of the partnership’s basis in the distributed property over the distributee-partner’s basis in its interest. If applicable, the distributee-partner’s basis in its interest is first reduced (but not below zero) by the amount of cash distributed to the partner.

### **Reasons for Change**

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

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

### **Proposal**

The proposal would reduce the ability of related parties to use a partnership to shift partnership basis among themselves for the purpose of creating advantageous tax results with no meaningful economic consequences. In the case of a distribution of partnership property that results in a step-up of the basis of the partnership’s non-distributed property, the proposal would apply a matching rule that would prohibit any partner in the distributing partnership that is related to the distributee-partner from benefitting from the partnership’s basis step-up until the distributee-partner disposes of the distributed property in a fully taxable transaction.

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

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

## CONFORM DEFINITION OF “CONTROL” WITH CORPORATE AFFILIATION TEST

### **Current Law**

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

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

### **Reasons for Change**

The control test under section 368(c) creates potential for taxpayers to improperly achieve desired tax outcomes through structured transactions. By carefully allocating voting power among the shares of a corporation, taxpayers can manipulate the section 368(c) control test in order to qualify or not qualify, as desired, a transaction as tax-free. For example, a taxpayer may structure a transaction in this manner to avoid tax-free treatment in order to recognize a loss. In addition, the absence of a value component under this standard allows corporations to retain control of a corporation but to “sell” a significant amount of the value of the corporation tax-free. A uniform ownership test for corporate transactions would reduce the complexity currently caused by these inconsistent tests.

### **Proposal**

The proposal would conform the control test under section 368(c) with the affiliation test under section 1504(a)(2). Therefore, “control” would be defined as the ownership of at least 80 percent of the total voting power and at least 80 percent of the total value of stock of a corporation. The term “stock” would not include certain preferred stock that meets the requirements of section 1504(a)(4).

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

## **STRENGTHEN LIMITATION ON LOSSES FOR NONCORPORATE TAXPAYERS**

### **Current Law**

Section 461(l) of the Internal Revenue Code (Code) provides that, for taxable years 2021 through 2028 (inclusive of the extensions under the American Rescue Plan Act of 2021 and the Inflation Reduction Act of 2022), any excess business losses are disallowed for noncorporate taxpayers. Excess business losses are the excess of current-year net business losses over a specified amount. In 2024, these specified amounts are \$610,000 for married couples filing jointly, and \$305,000 for all other taxpayers. These specified amounts are adjusted for inflation each year.

In determining the amount of an excess business loss, business losses for the taxable year exclude net operating loss (NOL) deductions and the 20 percent deduction for qualified business income under section 199A of the Code. Additionally, income, deductions, and gains attributable to a taxpayer's performance of services as an employee (e.g., wage income) are disregarded. Lastly, business income or gains include capital gain net income only when attributable to a trade or business.

Excess business losses may be carried forward and deducted as NOLs in subsequent years.

### **Reasons for Change**

In general, for individual taxpayers, non-passive losses from a business activity may offset income or gains from unrelated activities. There are several reasons why this is undesirable. First, evidence from randomized audits suggests that business losses are especially likely to be misreported on a taxpayer's Federal income tax return. The benefit of allowing business losses to offset other types of income or gain without limitation provides an additional incentive for such misreporting on the return.

Second, the ability to use business losses to offset unrelated income or gain creates a distortion in entity organization choice. The business losses may generate a reduction in tax liability much earlier if the business is organized as a pass-through entity rather than a C corporation because C corporation losses do not flow through to individual owners. As a result, C corporations' business losses cannot be deducted by individual owners of C corporations, and a C corporations' ability to deduct business losses (including those carried from prior years) is limited only to the extent they have business income or gain. By constraining individuals' abilities to offset income sources such as wages with nonpassive pass-through business losses, section 461(l) creates a more similar tax regime for business losses across different forms of business organization and types of business activity.

Section 461(l) is designed to reduce the ability of individual taxpayers to use business losses to offset unrelated income by capping net business losses at \$305,000 (or \$610,000 for married filing jointly taxpayers), indexed for inflation. However, under current law, section 461(l) contains a significant deficiency: the losses denied by section 461(l) in a current year become an NOL carryforward in the subsequent year, subject only to the general limitations in section 172 (e.g., NOLs may not reduce taxable income by more than 80 percent). For example, consider a

taxpayer who each year has a large amount of business losses, an even larger amount of non-business gains, and no other income. Section 461(l) effectively delays the benefit of the excess business loss for only one year. In contrast, under the proposal this taxpayer would never be able to benefit from the excess business loss.

### **Proposal**

The proposal would make permanent the excess business loss limitation. It would also treat excess business losses carried forward from the prior year as current-year business losses instead of as NOL deductions.

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

## **EXPAND LIMITATION ON DEDUCTIBILITY OF EMPLOYEE REMUNERATION IN EXCESS OF \$1 MILLION**

### **Current Law**

Section 162(m) of the Internal Revenue Code (Code) generally disallows a deduction by a publicly held corporation for compensation in excess of \$1 million paid to certain employees and former employees (“covered employees”) in a taxable year. Covered employees include the chief executive officer (CEO); chief financial officer (CFO); the three highest-paid non-CEO, non-CFO officers; or anyone who met these criteria for any previous taxable year (but not in taxable years beginning before December 31, 2016).

For taxable years beginning after December 31, 2026, the definition of covered employee is expanded to include the next five highest-paid employees.

The section 162(m) deduction disallowance rules apply to “applicable employee remuneration” in excess of \$1 million paid to a covered employee in the taxable year. In general, applicable employee remuneration means all otherwise-deductible compensation paid to an employee (or an employee’s beneficiary) for services performed, including cash and non-cash compensation, performance-based compensation, and commissions, regardless of when the services were performed. Certain types of compensation are not subject to the deduction disallowance and are not taken into account in determining whether other compensation exceeds \$1 million, including (a) certain grandfathered compensation payments, (b) payments made to a tax-favored retirement plan (including salary-reduction contributions), and (c) amounts that are excludable from the employee’s gross income, such as employer-provided health benefits and miscellaneous fringe benefits.

### **Reasons for Change**

The section 162(m) deduction disallowance rules generally increase the taxes owed by certain employers when they pay compensation above \$1 million. Increasing the tax liability associated with high compensation payments reduces the deficit, makes the Federal income tax system more progressive, and distributes the cost of government more fairly among taxpayers of various income levels.

However, under current law, the section 162(m) deduction disallowance rules apply only to publicly held corporations and only with respect to compensation in excess of \$1 million paid to a small number of covered employees. The limited application of the section 162(m) rules means that all compensation in excess of \$1 million paid by privately held corporations and compensation in excess of \$1 million paid by publicly held corporations to employees other than covered employees is fully deductible.

These scope-limiting rules introduce distortions and horizontal inequity. The current rules limiting a publicly held corporation’s compensation deduction, but not limiting the compensation deduction for a privately held corporation, may distort a business’s decision to remain private or to go public. Moreover, businesses with a smaller number of employees receiving compensation

in excess of \$1 million are relatively more affected by the current section 162(m), which unfairly favors the largest businesses.

In addition, under current law, section 162(m) does not include an entity aggregation rule, and the aggregation rule in the regulations is not as broad as the rules that generally apply in other similar contexts, in particular to employer-sponsored retirement plans and to other employee benefits. Some taxpayers have used the lack of a comprehensive aggregation rule to avoid the application of the deduction disallowance rules.

Moreover, some taxpayers have tried to avoid the application of the section 162(m) deduction disallowance rules by paying a covered employee's compensation from an affiliated partnership, rather than directly from the publicly held corporation.

### **Proposal**

The proposal would strengthen the deduction disallowance by amending section 162(m) to apply to all C corporations – publicly held and privately held – and to all compensation paid by the corporation in excess of \$1 million to any employee.

In addition, the proposal would further strengthen section 162(m) by closing some mechanisms taxpayers have used in an attempt to avoid the deduction limitation.

The proposal would add an aggregation rule that would treat all members of a controlled group within the meaning of section 414(b), (c), (m), and (o) of the Code as a single employer for purposes of determining the covered employees and applying the deduction disallowance for compensation paid to these employees in excess of \$1 million. The section 414 controlled group rules are the rules used to treat related entities as a single employer for other employee benefits purposes.

The proposal would amend section 162(m) to ensure that otherwise deductible compensation paid to an employee is considered “applicable employee remuneration”, subject to the deduction disallowance, whether or not paid directly by the corporation.

Finally, the proposal would expand the regulatory authority of the Secretary to issue regulations and other guidance as necessary to carry out the purposes of section 162(m) and to prevent the avoidance of the rule, including through the performance of services other than as an employee or by payment of compensation through a partnership or other pass-through entity.

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

## **PREVENT PRISON FACILITY RENT PAYMENTS FROM CONTRIBUTING TO QUALIFICATION AS A REIT**

### **Current Law**

If a C corporation qualifies as a Real Estate Investment Trust (REIT), it can deduct the dividends that it pays to its shareholders in order to avoid an entity-level tax on its income. To qualify as a REIT for a taxable year, the corporation must satisfy various criteria, including two income tests: (a) in general, at least 95 percent of its gross income for the year must be derived from sources on one list, and (b) at least 75 percent of its gross income for the year must be derived from sources on a second list. (Both lists include “rents from real property.”)

Even if, for some year, a corporation would not satisfy the 95 percent and/or the 75 percent test, the Secretary may treat some non-qualifying income as qualifying or may treat some non-qualifying income as not being gross income. These actions to cause the corporation to qualify as a REIT may be taken to the extent necessary to carry out the purposes of the REIT provisions of the Internal Revenue Code (Code) and apply only for purposes of those provisions.

REITs may own real estate assets of private for-profit prisons. Often the REIT owns the prison real estate assets and receives rents from the (possibly related) business that is operating the prison.

### **Reasons for Change**

A January 26, 2021, Executive Order forbade the Federal Department of Justice from entering any new or renewed contracts with privately operated criminal detention facilities.<sup>5</sup> The Executive Order described investigations that had uncovered situations in which “privately operated criminal detention facilities do not maintain the same levels of safety and security” as do governmentally operated facilities. In addition, it is important to “reduce profit-based incentives to incarcerate.”

Although the Executive Order has phased out private operation of Federal prisons, it does not affect REITs’ involvement with non-Federal facilities. The reasons underlying the Executive Order, however, make it inappropriate to provide the tax benefits of REIT status for the private operation of any detention facility.

### **Proposal**

The proposal would exclude from both the 95 percent and the 75 percent income lists any rent received from a prison or other detention facility. The exclusion would apply to rent from any rented property a substantial use of which is in connection with punishment, detention, or correction. Moreover, the Secretary would not have the ability under section 856(c)(5)(J) of the

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<sup>5</sup> Executive Order 14006: *Reforming Our Incarceration System To Eliminate the Use of Privately Operated Criminal Detention Facilities*, 2021. <https://www.govinfo.gov/content/pkg/DCPD-202100088/pdf/DCPD-202100088.pdf>

Code either to treat that rent as qualifying income, or to exclude it from gross income, for purposes of the REIT provisions of the Code.

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

## **REFORM INTERNATIONAL TAXATION**

### **REVISE THE GLOBAL MINIMUM TAX REGIME, LIMIT INVERSIONS, AND MAKE RELATED REFORMS**

#### **Current Law**

##### **Global minimum tax regime with respect to controlled foreign corporation earnings**

Any U.S. shareholder of a controlled foreign corporation (CFC) is taxed annually in the United States under the global minimum tax in Internal Revenue Code (Code) section 951A with respect to its CFCs (generally referred to as global intangible low-taxed income, or GILTI). A U.S. shareholder's global minimum tax inclusion is determined by combining its pro rata share of the tested income (or tested loss) of its CFCs. A CFC's tested income is the excess of certain gross income of the CFC over the deductions of the CFC that are properly allocable to the CFC gross tested income. A CFC's tested loss is the excess of the CFC's properly allocable deductions over the CFC's gross tested income. A U.S. shareholder's pro rata share of a CFC's tested loss may be used to offset the shareholder's pro rata share of the tested income of another CFC owned by the shareholder; however, if there is a net tested loss, the U.S. shareholder has no global minimum tax inclusion. Any unused loss may not be carried back or carried forward for use in another year.

The U.S. shareholder's actual global minimum tax inclusion reflects a reduction for a 10 percent return on qualified business asset investment (QBAI), which is generally foreign tangible property eligible for depreciation, such as buildings or machinery. QBAI does not include assets that are not depreciable (such as land) or intangible assets (such as patents, copyrights, and trademarks).

Under section 250, subject to a taxable income limitation, a corporate U.S. shareholder is generally allowed a 50 percent deduction against its global minimum tax inclusion. The section 250 deduction generally results in a 10.5 percent U.S. effective tax rate on a corporate U.S. shareholder's global minimum tax inclusion under the current U.S. corporate tax rate of 21 percent. The 50 percent deduction is scheduled to be reduced to 37.5 percent starting in 2026.

Certain foreign income taxes paid by a CFC are creditable against a corporate U.S. shareholder's U.S. tax liability attributable to its global minimum tax inclusion, including Pillar Two qualified domestic minimum top up tax (QDMTT) paid in a jurisdiction if they satisfy the requirements in section 901 or 903. The allowable credit is limited to 80 percent of the amount of the foreign income taxes properly allocable to a CFC's tested income taken into account as part of the global minimum tax inclusion. Unlike foreign income taxes allocated to other types of foreign source income, if a taxpayer cannot claim a credit for foreign income taxes associated with its global minimum tax inclusion in a given year because of the operation of the foreign tax credit (FTC) limitation, those foreign income taxes are not eligible to be carried back or carried forward for use in another taxable year.

Under Treasury regulations, if the foreign effective tax rate on the gross income of a CFC that would otherwise be part of a global minimum tax inclusion exceeds 90 percent of the U.S. corporate income tax rate, the U.S. shareholder of the CFC is generally permitted to exclude that gross income (and the associated deductions and foreign income taxes) from its global minimum tax inclusion. A similar statutory rule applies for purposes of certain Subpart F income, i.e., certain foreign income earned indirectly by U.S. persons at full U.S. tax rates.

A single FTC limitation generally applies to a corporate U.S. shareholder's global minimum tax inclusion. This means foreign income taxes paid to a high-tax foreign jurisdiction can be used to reduce the U.S. tax liability with respect to global minimum tax income earned in lower-tax jurisdictions. Thus, generally, a U.S. shareholder's aggregate U.S. tax (after accounting for the allocation of U.S. shareholder deductions) on its global minimum tax inclusion is reduced by reference to the average foreign effective tax rate on its aggregate global minimum tax income rather than the effective tax rates in each individual foreign jurisdiction where income is earned.

#### Deduction for dividends received from non-controlled foreign corporations

The Code provides different dividends received deductions for domestic corporate shareholders, depending on the nature of the dividend distributed, the shareholder's ownership level in the distributing corporation, and whether the distributing corporation is a domestic or foreign corporation. First, section 243 provides a dividends received deduction (section 243 DRD) for domestic corporate shareholders on distributions received from other domestic corporations. The amount of the section 243 DRD depends on the level of ownership in the domestic corporation. In general, if the domestic corporate shareholder is part of the same affiliated group as the distributing corporation, the section 243 DRD is 100 percent. If the domestic corporate shareholder owns at least 20 percent of the distributing corporation but is not affiliated with the distributing corporation, then the section 243 DRD is 65 percent; in all other cases, the section 243 DRD is 50 percent.

Under section 245, a domestic corporate shareholder generally is entitled to a dividends received deduction (section 245 DRD) for the U.S.-source portion of dividends received from certain foreign corporations. A foreign corporation qualifies for the section 245 DRD only if it is not a passive foreign investment company and at least 10 percent of the stock is owned by the domestic corporate shareholder. The amount of the section 245 DRD is based on the amount provided in section 243.

However, if a domestic corporation is a U.S. shareholder of a foreign corporation, in general, the domestic corporation is allowed a 100 percent dividends received deduction under Code section 245A (section 245A DRD) equal to the foreign-source portion of any dividend ("foreign-sourced dividend") received from that foreign corporation. For example, if the undistributed earnings of the foreign corporation are entirely foreign sourced, then this section 245A DRD allows the domestic corporation to receive a dividend from the foreign corporation without any increase in its U.S. tax burden. Under section 951(b), a U.S. shareholder is a U.S. person who owns at least 10 percent of the stock (by vote or value) of a foreign corporation.

A foreign corporation whose stock is majority owned directly or indirectly by U.S. shareholders is a CFC. When a CFC earns Subpart F income or tested income, U.S. shareholders are subject to current U.S. taxation (but eligible for FTCs) on their pro rata shares of that income under sections 951(a) and 951A(a) of the Code, respectively. When these previously taxed earnings and profits are remitted to U.S. shareholders, under section 959, those earnings are not subject to U.S. tax again.

#### Treatment of deductions properly allocable to exempt income

Certain dividends received by a domestic corporation from foreign corporations are effectively exempt from U.S. tax by reason of the section 245A DRD. Specifically, section 245A provides to a domestic corporation a deduction equal to the foreign-source portion of a dividend received from a specified 10 percent owned foreign corporation, but only if the domestic corporation is a U.S. shareholder of the foreign corporation.

Section 265(a)(1) generally disallows a deduction for any amount that is allocable to certain classes of income that are wholly exempt from U.S. tax. For purposes of determining a taxpayer's FTC limitation, tax exempt assets and their associated income are disregarded under section 864(e)(3). Section 904(b)(4) applies to disregard (solely for purposes of the FTC limitation) deductions allocable to income attributable to foreign stock other than global intangible low-taxed income (GILTI) or Subpart F income inclusions.

#### Limitations on the ability of domestic corporations to expatriate

Section 7874 applies to certain transactions (known as "inversion transactions") in which a U.S. corporation is acquired by a foreign corporation ("foreign acquiring corporation") in a transaction where (a) substantially all of the assets held directly or indirectly by the domestic corporation are acquired directly or indirectly by the foreign acquiring corporation; (b) the former shareholders of the domestic corporation hold at least a 60 percent ownership interest in the foreign acquiring corporation by reason of the acquisition; and (c) the foreign acquiring corporation, together with its expanded affiliated group, does not conduct substantial business activities in the country in which the foreign acquiring corporation is created or organized. Similar provisions apply to acquisitions of domestic partnerships. The tax consequences of an inversion transaction depend on the level of continuing former shareholder ownership. If the continuing former shareholder ownership of the foreign acquiring corporation is at least 80 percent (by vote or value), the foreign acquiring corporation is treated as a domestic corporation for all U.S. tax purposes (the "80 percent test"). If the continuing former shareholder ownership is at least 60 percent but less than 80 percent (by vote or value), the foreign acquiring corporation is respected as foreign but full U.S. tax must generally be paid with respect to certain income or gain recognized by the expatriated U.S. entity and its affiliates in connection with the inversion or within the ten-year period ending after the completion of the inversion (the "60 percent test"). Furthermore, the Tax Cuts and Jobs Act of 2017 adopted several anti-abuse provisions that apply to inversion transactions that satisfy the 60 percent test.

### Stock losses attributable to foreign income that was taxed at a reduced rate

Section 250 generally provides a 50 percent deduction (37.5 percent for taxable years beginning after December 31, 2025) for a global minimum tax inclusion, resulting in a 10.5 percent effective tax rate (13.125 percent for taxable years beginning after December 31, 2025) on this income (before taking FTCs into account). (This [General Explanation of the Administration's Fiscal Year 2025 Revenue Proposals](#) proposes to increase the corporate rate to 28 percent and reduce the section 250 deduction rate to 25 percent, resulting in a 21 percent effective tax rate on this income.) A global minimum tax inclusion increases a U.S. shareholder's basis in the stock of a CFC dollar-for-dollar (that is, without regard to the 50 percent deduction). Thus, if stock of a CFC is sold at a loss, the U.S. shareholder can take a deduction at the full value of the U.S. corporate tax rate. A similar result occurs if a U.S. shareholder had income inclusions with respect to a specified foreign corporation under the section 965 transition tax. This is because a section 965(c) deduction was allowed for a section 965 inclusion, resulting in a lower effective tax rate (prior to FTCs) on this income, but basis in the stock of the specified foreign corporation was increased dollar-for-dollar.

### Information reporting requirements for foreign business entities

Section 6038 generally requires a U.S. person who controls a foreign business entity (whether a corporation or partnership) to report certain information regarding such entity. The statute provides for penalties for a failure to report.

## **Reasons for Change**

### Global minimum tax regime with respect to CFC earnings

The reduction to global minimum tax inclusions for a percentage of certain foreign tangible assets incentivizes U.S. multinational companies to invest in tangible assets abroad rather than domestically. The elimination of QBAI would eliminate this perverse investment incentive while simplifying the taxation of CFCs.

The difference between the effective U.S. tax rate on global minimum tax inclusions and the effective U.S. tax rate on income earned directly by U.S. companies that results from the section 250 deduction incentivizes U.S. companies to locate profits and operations offshore. Reducing the section 250 deduction for these foreign earnings would reduce this perverse incentive.

The determination of a U.S. company's global minimum tax inclusion and residual U.S. tax liability on such inclusions on a global blended basis incentivizes U.S. companies with operations in high-tax jurisdictions to invest in lower-tax jurisdictions, to take advantage of the automatic global averaging under the existing global minimum tax regime. In some cases, U.S. companies may have an incentive to locate operations in jurisdictions with corporate income tax rates higher than the United States, to average these high taxes against low-taxed income earned elsewhere. This automatic blending feature exacerbates the race to the bottom on corporate income tax rates and encourages U.S. companies to report profits (as well as the activities that give rise to those profits) in offshore jurisdictions rather than in the United States, creating a

perverse “America last” tax policy. Similar global blending concerns arise with respect to high and low-taxed income earned through foreign branches.

In contrast, determining a taxpayer’s global minimum tax inclusion and residual U.S. tax liability on such inclusions on a jurisdiction-by-jurisdiction basis would be a stronger deterrent to profit shifting and offshoring because residual U.S. tax would be due on every dollar earned in a low-tax jurisdiction at the minimum rate, with no ability to reduce that residual U.S. tax for excess foreign taxes paid to higher-tax jurisdictions.

In a jurisdiction-by-jurisdiction system, high-tax income cannot be used to offset low-tax income from other jurisdictions. In contrast, as discussed above, current law allows more favorable global blending of income and tax. This favorable treatment is partially offset by restrictive rules for foreign tax credits and losses. Thus, in conjunction with the adoption of a jurisdiction-by-jurisdiction system, elimination of the QBAI exemption, and a higher effective GILTI rate, the proposal would also allow increased use of foreign tax credits and both foreign tax credit and loss carryforwards.

In December 2021, the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS) reached agreement on Model Rules under Pillar Two for a comprehensive jurisdiction-by-jurisdiction global minimum taxation regime that would help end the race to the bottom on corporate tax rates in a manner that puts the United States and other countries on a more level playing field.<sup>6</sup> Since that time, multiple jurisdictions have enacted legislation implementing some portion of Pillar Two. The Pillar Two “income inclusion rule” (IIR) applies on a “top down” basis. That is, it is applied only by the ultimate parent entity of a multinational group, and generally is not applied by lower tier holding companies. Therefore, in the case of foreign-controlled domestic corporations that own CFCs, the IIR is expected to be applied by the foreign parent with respect to low-taxed CFC income.

#### Deduction for dividends received from non-controlled foreign corporations

The section 245A DRD effectively exempts from U.S. taxation the foreign-sourced dividend of a CFC. With limited exceptions, for the earnings to be eligible for the section 245A DRD, the earnings must first be potentially subject to tax under the global minimum tax or Subpart F regimes (or be subject to a sufficiently high level of foreign tax). However, current law also effectively exempts the foreign-sourced dividend from a foreign corporation that is not a CFC, even though such earnings are not subject to tax under the global minimum tax or Subpart F regimes and may be subject to low or no tax in the foreign jurisdiction. Moreover, the section 245A DRD for the foreign-source earnings of non-CFCs (100 percent) is larger than the section

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<sup>6</sup> In December 2021, the OECD/G20 Inclusive Framework on BEPS reached agreement on Model Rules under Pillar Two for a comprehensive jurisdiction-by-jurisdiction global minimum taxation regime. OECD, *Tax Challenges Arising from the Digitalisation of the Economy Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS*, 2021. <https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.pdf>; OECD, *Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS*, 2021. <https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two-commentary.pdf>.

243 DRD available on dividends from domestic corporations or the section 245 DRD available on dividends from foreign corporations on U.S.-source income, where the shareholder owns 50 percent or less of the distributing corporation (50 to 65 percent).

#### Deductions attributable to income exempt from U.S. tax and taxed at preferential rates

To the extent deductions are claimed for expenses allocable to income eligible for a deduction under section 245A or section 250, on the basis that section 265 does not apply because that income is not “wholly exempt” from U.S. tax, the United States is providing a tax subsidy for foreign investment.

#### Limitations on the ability of domestic corporations to expatriate

To reduce their U.S. tax liabilities, certain domestic entities have been combining with smaller foreign entities in transactions that avoid the 80 percent test but that may satisfy the 60 percent test under section 7874. These combination transactions are typically structured so that the domestic entity and the foreign entity become subsidiaries of a newly formed foreign parent company. The domestic entities can often substantially reduce their U.S. income tax liability following these combination transactions with only a minimal change to their operations.

Inversion transactions raise significant policy concerns because they facilitate the erosion of the U.S. tax base through deductible payments by the U.S. members of the multinational group to the non-U.S. members and through aggressive transfer pricing for transactions between such U.S. and non-U.S. members. The inverted group also may reduce its U.S. taxes by reducing or eliminating altogether its direct and indirect U.S. ownership in foreign subsidiaries or assets. The adverse tax consequences under current law of 60 percent inversion transactions have not deterred taxpayers from pursuing these transactions. There is no policy reason to respect an inverted structure when the owners of a domestic entity retain a controlling interest in the group, only minimal operational changes are expected, and there is potential for substantial erosion of the U.S. tax base. Furthermore, an inverted structure should not be respected when the structure results from the combination of a larger U.S. group with a smaller entity or group and, after the transaction, the expanded affiliated group is primarily managed and controlled in the United States and does not have substantial business activities in the relevant foreign country, even if the shareholders of the domestic entity do not maintain control of the resulting multinational group.

#### Stock losses attributable to foreign income that was taxed at a reduced rate

Under current law, if an increase in stock basis from an inclusion under section 951A or section 965 results in a loss on the sale or other disposition of the stock, the loss may inappropriately be available to offset income or gain that would be subject to the full corporate tax rate even though the income inclusion that gave rise to the basis was subject to tax at a reduced rate.

#### Definition of foreign business entity

Because of the shift in emphasis to apply the global minimum tax, Subpart F, and the FTC rules using a jurisdiction-by-jurisdiction taxable unit standard, there is a need to collect information at

the same level, with respect to each taxable unit in a foreign jurisdiction. By obtaining accurate information on each taxable unit, compliance and enforcement efforts would be improved. To further improve compliance, penalties for failure to provide information should also apply for reporting failures at the taxable unit level.

## **Proposal**

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

The proposal would make several changes to the existing global minimum tax system. First, the QBAI exemption would be eliminated, so that the U.S. shareholder's entire net CFC tested income is subject to U.S. tax. Second, the section 250 deduction for a global minimum tax inclusion would be reduced to 25 percent, generally increasing the U.S. effective tax rate under the global minimum tax (to 21 percent under the proposed U.S. corporate income tax rate of 28 percent). Third, the “global averaging” method for calculating a U.S. shareholder’s global minimum tax would be replaced with a “jurisdiction-by-jurisdiction” calculation. Under the new standard, a U.S. shareholder’s global minimum tax inclusion and, by extension, residual U.S. tax on such inclusion, would be determined separately for each foreign jurisdiction in which its CFCs have operations. This means a separate FTC limitation would apply for each foreign jurisdiction. A similar jurisdiction-by-jurisdiction approach would also apply with respect to a U.S. taxpayer’s foreign branch income. These changes mean that foreign taxes paid to higher-taxed jurisdictions will no longer reduce the residual U.S. tax paid on income earned in lower-taxed foreign jurisdictions. As under current law, Pillar Two QDMTTs paid in a jurisdiction may be creditable against GILTI liability in that jurisdiction if they satisfy the requirements in section 901 or 903.

With respect to the global minimum tax, the proposal would decrease the 20 percent disallowance of FTCs incurred to five percent, would allow net operating losses (NOLs) to be carried forward (within a single jurisdiction), and would allow FTCs to be carried forward ten years (within a single jurisdiction). In each case, the carryover would be at the U.S. shareholder level.

The proposal would also repeal the high-tax exemption to Subpart F income and the cross-reference to that provision in the global minimum tax regulations issued under section 951A.

A domestic corporation that is a member of a foreign-parented controlled group generally owes residual U.S. tax when it has a global minimum tax inclusion. The proposal would account for any foreign taxes paid by the foreign parent, under an IIR that is consistent with the OECD/Inclusive Framework Pillar Two Model Rules on global minimum taxation, with respect to the CFC income that would otherwise be part of the domestic corporation’s global minimum tax inclusion. The proposal’s jurisdiction-by-jurisdiction approach would also apply for this purpose.

The reduction in the section 250 deduction to 25 percent would be effective for taxable years beginning after December 31, 2023. The other elements of the proposal in this section would be effective for taxable years beginning after December 31, 2024.

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

The proposal would limit the section 245A DRD to only those dividends remitted either by CFCs or by qualified foreign corporations, which includes corporations incorporated in a territorial possession of the United States and certain corporations eligible for the benefits of a comprehensive income tax treaty. A U.S. shareholder would receive a section 245A DRD equal to 65 percent of the foreign-sourced dividends received from a qualified foreign corporation that is not a CFC if the U.S. shareholder owns at least 20 percent of the stock (by vote and value) of the qualified foreign corporation. Otherwise, if a U.S. shareholder owns less than 20 percent (by vote or value) of the stock of a qualified foreign corporation that is not a CFC, the U.S. shareholder would receive a section 245A DRD equal to 50 percent of the foreign-sourced dividends received.

The DRD would remain unchanged for dividends received from CFCs.

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

### Reform the treatment of deductions properly allocable to exempt income

The proposal would expand the application of section 265 to disallow deductions allocable to a class of foreign gross income that is exempt from tax or taxed at a preferential rate through a deduction (e.g., a global minimum tax inclusion with respect to which a section 250 deduction is allowed or dividends eligible for a section 245A deduction).<sup>7</sup> The proposal would provide rules for determining the amount of disallowed deductions when only a partial deduction is allowed under section 245A with respect to a dividend or a partial section 250 deduction with respect to a global minimum tax inclusion. The proposal would also repeal section 904(b)(4).

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

### Limit the ability of domestic corporations to expatriate

The proposal would broaden the definition of an inversion transaction by replacing the 80 percent test with a greater than 50 percent test and eliminating the 60 percent test. The proposal would also provide that, regardless of the level of shareholder continuity, an inversion transaction occurs if (a) immediately prior to the acquisition, the fair market value of the domestic entity is greater than the fair market value of the foreign acquiring corporation, (b) after the acquisition the expanded affiliated group is primarily managed and controlled in the United States, and (c) the expanded affiliated group does not conduct substantial business activities in the country in which the foreign acquiring corporation is created or organized. The proposal would also expand the scope of an acquisition for purposes of section 7874 to include a direct or indirect acquisition of substantially all of the assets constituting a trade or business of a domestic corporation, substantially all of the assets of a domestic partnership, or substantially all of the U.S. trade or business assets of a foreign partnership. Furthermore, a distribution of stock of a foreign corporation by a domestic corporation or a partnership that represents either substantially

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<sup>7</sup> As is true for all proposals described this volume, this proposal is not intended to create any inferences regarding current law, including whether section 265 currently applies to this income.

all of the assets or substantially all of the assets constituting a trade or business of the distributing corporation or partnership would be treated as a direct or indirect acquisition of substantially all of the assets or trade or business assets, respectively, of the distributing corporation or partnership. The Secretary would be granted regulatory authority to exempt certain internal restructurings involving partnerships from the application of section 7874 and to define a trade or business for purposes of section 7874.

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

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

The rules for basis in the stock of a foreign corporation would be amended to provide that, for purposes of determining loss on a U.S. shareholder's disposition of stock of a foreign corporation, the basis in stock of the foreign corporation is reduced (but not below zero) by the sum of (a) the section 245A DRDs allowed to the U.S. shareholder with respect to the stock, (b) the deductions for GILTI inclusions that are attributable to the stock, and (c) the deductions for income inclusions under the section 965 transition tax that are attributable to the stock. In addition, the principles of the proposal would apply to reduce the basis in other property by reason of which a domestic corporate U.S. shareholder owns stock of a foreign corporation under section 961(a). Finally, the proposal would apply to successors of the basis in stock or other property subject to the proposal and to exchanged basis property or similar property.

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

#### Expand the definition of foreign business entity to include taxable units

The proposal would expand the definition of foreign business entity to treat any taxable unit in a foreign jurisdiction as a "foreign business entity" for purposes of applying section 6038. Thus, information would be required to be reported separately with respect to each taxable unit, and penalties would apply separately for failures to report with respect to each taxable unit. To harmonize the reporting with the annual accounting period for which taxable income of a branch or disregarded entity is determined, the proposal would also provide that, except as otherwise provided by the Secretary, the annual accounting period for a taxable unit that is a branch or disregarded entity is the annual accounting period of its owner. For example, if a domestic corporation or a CFC conducts activities in a foreign branch or owns a foreign disregarded entity, the annual accounting period of the foreign branch or foreign disregarded entity generally would be the annual accounting period of the domestic corporation or CFC, respectively. Finally, for a taxpayer who is a U.S. person (as defined in section 7701(a)(30) of the Code) but who is a resident of a foreign jurisdiction, the proposal would provide the Secretary with the authority to treat the taxpayer as a resident of the United States for the purpose of identifying a taxable unit subject to reporting under section 6038.

The proposal would apply to taxable years of a controlling U.S. person that begin after December 31, 2024, and to annual accounting periods of foreign business entities that end with or are within such taxable years of the controlling U.S. person.

## **ADOPT THE UNDERTAXED PROFITS RULE**

### **Current Law**

Section 59A of the Internal Revenue Code (Code) imposes a Base Erosion Anti-Abuse Tax (BEAT) liability on certain corporate taxpayers in addition to their regular tax liability. Liability for BEAT is generally limited to corporate taxpayers with substantial gross receipts that make deductible payments to foreign related parties above a specified threshold (referred to as a “base erosion payment”). Taxpayers potentially liable for this additional tax have three-year average gross receipts in excess of \$500 million and a “base erosion percentage” exceeding a specified threshold. The base erosion percentage is generally determined by dividing the taxpayer’s “base erosion tax benefits” by the amount of all deductions allowed to the taxpayer for the taxable year.<sup>8</sup>

A taxpayer’s BEAT liability is computed by referencing the taxpayer’s “modified taxable income” and comparing the resulting amount to the taxpayer’s regular tax liability. For purposes of this calculation, regular tax liability is reduced by some but not all credits. When calculating BEAT liability for taxable years beginning after December 31, 2025, regular tax liability is reduced by all credits. A taxpayer’s modified taxable income is equal to its regular taxable income increased by base erosion tax benefits with respect to base erosion payments and an adjustment for the taxpayer’s net operating loss (NOL) deduction, if any. The taxpayer’s BEAT liability generally equals the difference, if any, between 10 percent of the taxpayer’s modified taxable income and the taxpayer’s regular tax liability (as reduced by certain credits against such tax). For taxable years beginning after December 31, 2025, the relevant BEAT rate increases to 12.5 percent.<sup>9</sup>

### **Reasons for Change**

On October 8, 2021, the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS) reached a comprehensive agreement on minimum taxation under Pillar Two, and on December 20, 2021, it published Model Rules describing two interlocking Pillar Two rules: (a) an income inclusion rule (IIR), which imposes top-up tax on a parent entity with respect to the low-taxed income of a member of its financial reporting group; and (b) an undertaxed profits rule (UTPR), which denies deductions or requires an equivalent adjustment to tax liability to the extent that the low-taxed income of a member of the group is not subject to an IIR.<sup>10</sup> Since that time, multiple jurisdictions have enacted legislation implementing some portion of Pillar Two.

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<sup>8</sup> Under current Treasury regulations, taxpayers can avoid a BEAT liability by electing to “waive” enough deductions for payments made to related foreign persons sufficient to remain below the base erosion percentage threshold.

<sup>9</sup> For all periods, the relevant BEAT rate is one percentage point higher for certain banks and registered securities dealers.

<sup>10</sup> In December 2021, the OECD/G20 Inclusive Framework on BEPS reached agreement on Model Rules under Pillar Two for a comprehensive jurisdiction-by-jurisdiction global minimum taxation regime: OECD *Base Erosion and Profit Shifting Project: Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy*, October 2021. <https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf>; and OECD, *Tax*

In conjunction with the global intangible low-taxed income (GILTI) regime, adopting the UTPR ensures that income earned by a multinational company, whether parented in the United States or elsewhere, is subject to a minimum rate of taxation regardless of where the income is earned. Just as the GILTI proposal (see [Revise the Global Minimum Tax Regime, Limit Inversions, and Make Related Reforms](#)) ensures that a minimum per-jurisdiction rate of tax is paid by U.S.-based multinationals on income earned through controlled foreign corporations (CFCs), the UTPR ensures that a minimum per-jurisdiction rate of tax is paid on income earned in each jurisdiction in which foreign-parented multinationals operate. This ensures that companies cannot avoid a minimum rate of taxation by, for example, relocating their headquarters to a foreign jurisdiction that has not implemented an IIR. The UTPR is designed to encourage countries to adopt the global minimum tax agreed to as part of the international negotiations by ensuring that profits in low-tax jurisdictions are taxed at the same minimum rate.

The proposal would increase alignment between the U.S. international tax rules and the international system emerging from Pillar Two. In addition, the UTPR has the potential to address the concern of erosion of the U.S. corporate tax base more fully and evenly. For example, the BEAT does not apply comprehensively to cost of goods sold, or COGS, of manufacturing companies in the same manner that it applies to deductions incurred by services firms. Further, firms with lower profit margins are more likely to have a BEAT liability than similarly situated firms with higher profit margins because the BEAT is a form of alternative minimum tax that effectively claws back a percentage of deductions above a threshold level.

### **Proposal**

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

The UTPR would disallow domestic corporations' and domestic branches' of foreign corporations U.S. tax deductions in an amount determined by reference to low-taxed income of foreign entities and foreign branches that are members of the same financial reporting group (including the common parent of the financial reporting group).<sup>11</sup> However, the UTPR would not apply with respect to income subject to an IIR that is consistent with the Pillar Two Model Rules,

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*Challenges Arising from the Digitalisation of the Economy Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS, 2021.* <https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.pdf>.

<sup>11</sup> A financial reporting group is any group of business entities that prepares consolidated financial statements and that includes at least one domestic entity or domestic branch and at least one foreign entity or foreign branch. Consolidated financial statements means those determined in accordance with U.S. Generally Accepted Accounting Principles (GAAP), International Financial Reporting Standards (IFRS), or other methods authorized by the Secretary under regulations. Under the proposal, the Secretary would be delegated authority to treat a group of business entities as a financial reporting group if a financial reporting group would exist had those business entities been required to prepare consolidated financial statements.

which would include income that is subject to GILTI, reformed as proposed. Thus, the UTPR would generally not apply to U.S.-parented multinationals.

The UTPR would primarily apply to foreign-parented multinationals with operations in low-tax jurisdictions. In addition, the UTPR would only apply to financial reporting groups that have global annual revenue of the dollar equivalent to €750 million or more in at least two of the prior four years.

Under the proposal, when UTPR applies, domestic group members would be disallowed U.S. tax deductions to the extent necessary to collect the hypothetical amount of top-up tax required for the financial reporting group to pay an effective tax rate of at least 15 percent in each foreign jurisdiction in which the group has profits.<sup>12</sup> The amount of this top-up tax would be determined based on a jurisdiction-by-jurisdiction computation of the group's profit and effective tax rate consistent with the Pillar Two Model Rules, which would take into account all income taxes, including the corporate alternative minimum tax. As discussed below, the top-up amount would be allocated among all of the jurisdictions where the financial reporting group operates that have adopted a UTPR consistent with the Pillar Two Model Rules (a Qualified UTPR).

The computation of profit and the effective tax rate for a jurisdiction is based on the group's consolidated financial statements, with certain specified adjustments such as rules to address temporary and permanent differences between the financial accounting and tax bases. In addition, the computation of a group's profit for a jurisdiction is reduced by an amount equal to 5 percent of the book value of tangible assets and payroll with respect to the jurisdiction.<sup>13</sup>

In addition to the general limitation of the UTPR to financial reporting groups that have global annual revenue of at least the dollar equivalent of €750 million, the proposal includes several de minimis exclusions. The UTPR would not apply to a group's profit in a jurisdiction if the three-year average of the group's revenue in the jurisdiction is less than \$10.9 million and the three-year average of the group's profit in the jurisdiction is less than \$1.09 million.<sup>14</sup> Under an exception for groups in the initial phase of their international activity, the UTPR would not apply to a group with operations in no more than five jurisdictions outside of the group's primary jurisdiction and the book value of the group's tangible assets in those jurisdictions is less than \$55 million. This exception would expire five years after the first day of the first year in which the UTPR otherwise would apply to the group.

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<sup>12</sup> For example, a group with \$1,000x of profits in a foreign jurisdiction with no corporate income tax would have a top-up tax amount of \$150x with respect to that jurisdiction. If the top-up tax were not collected under GILTI or an IIR implemented by a foreign jurisdiction, a domestic corporation or domestic branch that is a member of the group would be subject to a deduction disallowance of \$536x, equal to the top-up tax amount of \$150x divided by the U.S. corporate income tax rate of 28 percent. For simplicity, this example assumes that there are no tangible assets or payroll in the foreign jurisdiction with no corporate income tax, and that there are no other jurisdictions with a UTPR such that all of the top-up tax is allocated to the domestic corporation or domestic branch.

<sup>13</sup> During a transition period of nine years, the exclusion equals 7.8 percent of the book value of tangible assets and 9.8 percent of payroll, declining annually by 0.2 percentage points for the first four years, by 0.4 percentage points for tangible assets and by 0.8 percentage points for payroll for the last five years.

<sup>14</sup> Under the proposal, the Secretary would be delegated authority to adjust dollar-based thresholds to address currency fluctuations for international standards reflected in Euros.

The deduction disallowance applies pro rata with respect to all otherwise allowable deductions,<sup>15</sup> and applies after all other deduction disallowance provisions in the Code. To the extent that the UTPR disallowance for a taxable year exceeds the aggregate deductions otherwise allowable to the taxpayer for that year, such excess amount of the UTPR disallowance would be carried forward indefinitely until an equivalent amount of deductions are disallowed in future years.

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

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

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

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

Whether a foreign jurisdiction has in effect a Qualified UTPR or an IIR that is consistent with the Pillar Two Model Rules would be determined by the Secretary under the standard specified in the Pillar Two Model Rules.

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

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<sup>15</sup> For example, if a taxpayer incurs \$50x of interest expense that would otherwise be deductible and would otherwise be allowed a \$50x depreciation deduction, a UTPR disallowance of \$20x would disallow a deduction for \$10x of the interest expense and \$10x of the depreciation.

The proposal to repeal the BEAT and replace it with the UTPR would be effective for taxable years beginning after December 31, 2024.

## **REPEAL THE DEDUCTION FOR FOREIGN-DERIVED INTANGIBLE INCOME**

### **Current Law**

Current law provides a deduction to domestic corporations on their foreign-derived intangible income (FDII). The deduction allowed is 37.5 percent of a domestic corporation's FDII for any taxable year beginning after December 31, 2017, and 21.875 percent for any taxable year beginning after December 31, 2025. A domestic corporation's FDII is the portion of its intangible income, determined on a formulaic basis, that is derived from exports. The formulaic calculation of income eligible for the FDII deduction is generally determined by taking a domestic corporation's overall income, minus certain exceptions, and reducing it by a deemed tangible income return which is 10 percent of a domestic corporation's qualified business asset investment to arrive at a domestic corporation's deemed intangible income. A portion of this amount is treated as FDII based on the percentage of the taxpayer's income that is derived from serving foreign markets.

### **Reasons for Change**

FDII is not an effective way to encourage research and development (R&D) in the United States. It provides large tax breaks to companies with excess profits – who are already reaping the rewards of prior innovation – rather than incentivizing new domestic investment. Further, FDII disadvantages domestic producers, offering tax incentives only to those companies with high export sales, rather than those with significant domestic sales.

In addition, FDII creates undesirable incentives to locate certain economic activity abroad. Because the preferential FDII rate applies to income in excess of a domestic corporation's tangible assets, firms can lower the hurdle necessary to obtain preferential tax treatment by reducing tangible investments in the United States. Coupled with the current global intangible low-taxed income (GILTI) regime, there is a strong incentive for companies to offshore plants and equipment, since moving equipment offshore both increases the tax-free return under GILTI and increases the tax deduction under FDII.

Finally, eliminating FDII will raise significant revenue that can be deployed to incentivize R&D in the United States directly and more effectively.

### **Proposal**

The proposal would repeal the deduction allowed for FDII. The resulting revenue will be used to encourage R&D.

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

## **REVISE THE RULES THAT ALLOCATE SUBPART F INCOME AND GILTI BETWEEN TAXPAYERS TO ENSURE THAT SUBPART F INCOME AND GILTI ARE FULLY TAXED**

### **Current Law**

A controlled foreign corporation (CFC) is a foreign corporation whose stock is majority owned by U.S. shareholders (taking into account stock attribution rules). Section 951(a) of the Internal Revenue Code (Code) generally requires a U.S. shareholder of a CFC to include in gross income its pro rata share of the CFC's Subpart F income. A U.S. shareholder is required to include this amount only if the U.S. shareholder directly or indirectly owns stock in the foreign corporation on the last day of the foreign corporation's taxable year on which it is a CFC (the "last relevant day").

In general, a U.S. shareholder's pro rata share of Subpart F income is based on the amount of current year earnings and profits that the U.S. shareholder would receive if the CFC were to distribute all its current year earnings and profits on the last relevant day. However, a U.S. shareholder's pro rata share is reduced by the portion of the year during which the foreign corporation was not a CFC and by any dividends paid by the CFC during the year to another person with respect to stock of the CFC that the U.S. shareholder owns on the last relevant day. The reduction for dividends paid is limited to the CFC's Subpart F income allocable to the period that the U.S. shareholder did not own the stock of the CFC.

Thus, a dividend paid to a corporate U.S. shareholder with respect to the stock of a CFC that the U.S. shareholder sells may reduce the tax burden on the U.S. shareholder who subsequently purchases the stock in the same year. This is the case even though the selling U.S. shareholder may not pay any tax on the dividend because it is eligible for a dividends received deduction under section 245A of the Code (section 245A DRD).

A U.S. shareholder's pro rata share of a CFC's tested income, which is used to determine its global intangible low-taxed income (GILTI) inclusion under section 951A(a) of the Code, is determined based on the pro rata share rules for Subpart F income.

### **Reasons for Change**

Current law allows Subpart F income (or tested income) of a CFC to escape U.S. taxation in certain cases in which stock of the CFC is transferred and the CFC distributes a dividend (including a deemed dividend) to any person other than the U.S. shareholder on the last relevant day.

To illustrate the potential tax avoidance, suppose a corporate U.S. shareholder (the "seller") owns 50 percent of the single class of outstanding stock of a CFC at the beginning of the CFC's tax year. The CFC pays a dividend of \$80 to the seller, and then three-quarters of the way into the tax year, the seller sells all of its stock of the CFC to another U.S. shareholder (the "buyer"). The CFC earns \$200 of Subpart F income for its tax year. Without taking into account the dividend, the buyer's pro rata share of the CFC's Subpart F income would be \$100 (50 percent of

\$200). Because the \$80 dividend received by the seller is greater than \$75 (the portion of the Subpart F income allocable to the period the stock of the CFC is owned by the seller and not the buyer), the buyer's pro rata share of the CFC's Subpart F income is reduced by \$75 to \$25. Furthermore, the seller is generally allowed a 100 percent section 245A DRD. As a result, the dividend does not increase the seller's taxable income. Thus, in effect, \$75 of the CFC's Subpart F income has escaped U.S. taxation by reason of the sale.

Regulations issued under section 245A of the Code limit this type of tax avoidance in certain cases when a U.S. shareholder owns, directly or indirectly, more than 50 percent of the stock of a CFC, but do not address all cases, such as the previous example, where the seller owns 50 percent or less of the CFC.

### **Proposal**

The proposal would modify the existing pro rata share rules to require a U.S. shareholder of a CFC that owns, directly or indirectly, a share of stock of the CFC for part of the CFC's taxable year, but not on the last relevant day, to include in gross income a portion of the foreign corporation's Subpart F income allocable to the portion of the year during which it was a CFC. That portion of Subpart F income would equal the portion of the CFC's current year earnings and profits paid as non-taxed current dividends on the share while it was a CFC. A non-taxed current dividend is the portion of a dividend paid out of current year earnings and profits that, without regard to the proposal, either (a) is paid to a U.S. shareholder and would qualify for a dividends received deduction, or (b) to the extent prescribed by the Secretary, is paid to an upper-tier CFC.

The remaining portion of a CFC's Subpart F income that is allocable to the portion of the year during which it was a CFC – that is, the amount that is not allocated under the non-taxed current dividend rule – would be allocated to a U.S. shareholder that owns a share of stock of the CFC on the last relevant day. Similar to current law, a U.S. shareholder's pro rata share of Subpart F income with respect to the share of stock would be reduced for taxable dividends paid by the foreign corporation, provided the taxable dividends are paid while it was a CFC, out of current year earnings and profits, and are paid either (a) to another United States person, or (b), to the extent prescribed by the Secretary, to another CFC. However, the U.S. shareholder's pro rata share would not be reduced below the portion attributable to the portion of the year during which the U.S. shareholder owned the share.

Because the proposal applies on a share-by-share basis, a U.S. shareholder may be allocated Subpart F income under both the non-taxed current dividend rule and the last relevant day rule.

The proposal would similarly revise the pro rata share rules for determining a U.S. shareholder's GILTI inclusion with respect to a CFC.

The Secretary would be authorized to issue regulations or other guidance necessary or appropriate to carry out the purposes of the proposal, including (a) to treat distributions and other amounts as dividends or not dividends for purposes of this section, (b) to treat a partnership as an aggregate of its partners, (c) to provide rules allowing or requiring a foreign corporation to close its taxable year upon a change in ownership for purposes of determining U.S. shareholders' pro

rata share, and (d) to treat a distribution and related issuance of stock to a shareholder not subject to tax under this chapter in the same manner as an acquisition of stock.

The proposal would apply to taxable years of foreign corporations beginning after the date of enactment and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

## **REQUIRE A CONTROLLED FOREIGN CORPORATION'S TAXABLE YEAR TO MATCH THAT OF ITS MAJORITY U.S. SHAREHOLDER**

### **Current Law**

A controlled foreign corporation (CFC) is a foreign corporation whose stock is majority owned by U.S. shareholders (taking into account stock attribution rules). Section 898(c) of the Internal Revenue Code requires a CFC to use the same taxable year as its majority U.S. shareholder but provides an election to use a taxable year that ends one month earlier than the majority U.S. shareholder's taxable year. This provision, which was enacted in 1989, was intended to alleviate potential difficulties in obtaining and translating tax information from a foreign entity. The ability of a CFC to use a different taxable year than its majority U.S. shareholder permits the U.S. shareholder to defer income inclusions related to the income of the CFC.

### **Reasons for Change**

Technological advances have reduced or eliminated the difficulties in obtaining and translating tax information from a foreign entity. In addition, the ability to choose a different taxable year from that of the majority U.S. shareholder has resulted in aggressive tax planning opportunities for taxpayers, unnecessary complexity, and significant compliance and administrative burdens.

### **Proposal**

The proposal would eliminate the election for a CFC to use a taxable year different from the taxable year of the CFC's majority U.S. shareholder.

The proposal would be effective as of the date of enactment. CFCs with existing one-month deferral elections would have a short taxable year as of the first taxable year end of its majority U.S. shareholder that is at least 60 days after the date of enactment of the proposal.

## LIMIT FOREIGN TAX CREDITS FROM SALES OF HYBRID ENTITIES

### Current Law

A corporation that makes a qualified stock purchase of a target corporation is permitted to elect, under section 338 of the Internal Revenue Code (known as a “section 338 election”) to treat the stock acquisition as an asset acquisition for U.S. tax purposes, thereby generally adjusting the post-acquisition tax basis of the target corporation’s assets to fair market value. For this purpose, a qualified stock purchase is any transaction or series of transactions in which the purchasing corporation acquires at least 80 percent of the stock of the target corporation. Section 338(h)(16) provides that (subject to certain exceptions) the deemed asset sale resulting from a section 338 election is generally ignored in determining the source or character of any item for purposes of applying the foreign tax credit rules to the seller. Instead, for these purposes, any gain recognized by the seller is treated as gain from the sale of the stock of the target corporation. Thus, in the case of a foreign target corporation, section 338(h)(16) prevents the earnings and profits generated from the deemed asset sale from changing the character of the gain from capital to ordinary, thereby permitting the use of foreign tax credits (FTCs) to reduce or eliminate residual U.S. tax on the stock gain.

Similar to a section 338 election, Treasury regulations under section 336(e) allow a corporation to elect to treat certain dispositions of stock of a domestic corporation (but not a foreign corporation) as a disposition of the assets of the domestic corporation instead. These regulations apply section 338(h)(16) to a deemed sale of foreign assets of the domestic corporation.

### Reasons for Change

Section 338(h)(16) applies to a qualified stock purchase for which a section 338 election is made, but it does not apply to transactions that produce similar results – sales of an interest in an entity that is treated as a corporation for foreign tax purposes but as a partnership or a disregarded entity for U.S. tax purposes (specified hybrid entity), or taxable changes in the classification of an entity for U.S. tax purposes that are not recognized for foreign tax purposes. These transactions present the same FTC concerns as in the case of a qualified stock purchase for which a section 338 election is made, and so should be subject to similar limitations.

### Proposal

The proposal would apply the principles of section 338(h)(16) to determine the source and character of any item recognized in connection with a direct or indirect disposition of an interest in a specified hybrid entity and to a change in the classification of an entity that is not recognized for foreign tax purposes (for example, due to an election under the entity classification regulations). Thus, for purposes of applying the foreign tax credit rules, the source and character of any item resulting from the disposition of the interest in the specified hybrid entity, or change in entity classification, would be determined based on the source and character of an item of gain or loss that the seller would have accounted for upon the sale or exchange of stock (determined without regard to section 1248). In addition, because the proposal is limited to determining the source and character of such an item of gain or loss for purposes of applying the foreign tax

credit rules, the proposal does not affect the amount of gain or loss recognized as a result of the disposition or the change in entity classification. The Secretary would be granted authority to issue any regulations necessary or appropriate to carry out the purposes of the proposal, including those applying the proposal to other transactions that have a similar effect and exempting certain transactions among related parties from application of the proposal.

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

## **RESTRICT DEDUCTIONS OF EXCESSIVE INTEREST OF MEMBERS OF FINANCIAL REPORTING GROUPS**

### **Current Law**

Business interest expense generally is deductible from regular taxable income. An exception to this general rule is section 163(j) of the Internal Revenue Code (Code), which generally limits U.S. tax deductions for business interest expense to the sum of (a) business interest income, (b) 30 percent of adjusted taxable income (not less than zero), and (c) floor plan financing interest. Business interest expense for which a deduction is disallowed under section 163(j) may be carried forward indefinitely for deduction in a subsequent year.

Certain interest paid to a foreign related party is treated as a base erosion payment for purposes of the base erosion and anti-abuse tax (BEAT), in which case the deduction is added back to the BEAT modified taxable income base. See [Adopt the Undertaxed Profits Rule](#) earlier in this volume for a description of the relevant law.

In addition, certain interest paid to a foreign related party may not be deductible by reason of the anti-hybrid rules of section 267A, which limit deductibility of an interest payment when the amount is not included in the income of the recipient under foreign tax laws or when the recipient receives a deduction with respect to the payment. Furthermore, certain rules under the Code affect the timing of a deduction for interest. For example, certain interest owed to a related party may not be deductible to the payor by reason of section 267(a) until the interest is included in the gross income of the related-party payee.

In addition, both case law and regulations issued under section 385 can determine whether an instrument issued by an entity is treated as indebtedness that gives rise to interest expense for Federal income tax purposes, or as stock. Specifically, regulations under section 385 treat as stock certain debt instruments issued by a corporation to a controlling shareholder in a distribution or in certain other related-party transactions that achieve an economically similar result.

### **Reasons for Change**

The fungibility of money makes it easy for multinational groups to substitute debt for equity in a controlled entity in order to shift profits to lower-tax jurisdictions. Under current law, multinational groups are able to reduce their U.S. tax on income earned from U.S. operations by over-leveraging their U.S. operations relative to those located in lower-tax jurisdictions. Although section 163(j) limits the amount of interest expense a corporation can deduct relative to its U.S. earnings, section 163(j) does not consider the leverage of a multinational group's U.S. operations relative to the leverage of the group's worldwide operations. In addition, while certain interest paid to a foreign related party is added to the modified taxable income base for determining a taxpayer's BEAT liability, many taxpayers are able to avoid a BEAT liability because of the various exceptions for certain deductible payments. Moreover, the BEAT rate is less than half of the regular corporate income tax rate. (See [Adopt the Undertaxed Profits Rule](#) in this volume.) The proposal would limit the ability of multinational groups to lower U.S. taxable

income through high interest-to-income ratios for U.S. operations relative to the worldwide group.

### **Proposal**

Under the proposal, a financial reporting group (defined below) member's deduction for interest expense generally would be limited if the member has net interest expense for U.S. tax purposes and the member's net interest expense for financial reporting purposes (computed on a separate company basis) exceeds the member's proportionate share of the financial reporting group's net interest expense reported on the group's consolidated financial statements (excess financial statement net interest expense). A member's proportionate share of the financial reporting group's net interest expense would be determined based on the member's proportionate share of the group's earnings (computed by adding back net interest expense, tax expense, depreciation, depletion, and amortization) reflected in the financial reporting group's consolidated financial statements. The proposal generally would apply to an entity that is a member of a multinational group that prepares consolidated financial statements ("financial reporting group") in accordance with U.S. Generally Accepted Accounting Principles (GAAP), International Financial Reporting Standards (IFRS), or other method identified by the Secretary under regulations.

When a financial reporting group member has excess financial statement net interest expense, a deduction will be disallowed for the member's excess net interest expense for U.S. tax purposes. For this purpose, the member's excess net interest expense equals the member's net interest expense for U.S. tax purposes multiplied by the ratio of the member's excess financial statement net interest expense to the member's net interest expense for financial reporting purposes. Conversely, if a member's net interest expense for financial reporting purposes is less than the member's proportionate share of the net interest expense reported on the group's consolidated financial statements, such excess limitation would be converted into a proportionate amount of excess limitation for U.S. tax purposes and carried forward three years.

Alternatively, if a financial reporting group member fails to substantiate its proportionate share of the group's net interest expense for financial reporting purposes, or a member so elects, the member's interest deduction would be limited to the member's interest income plus ten percent of the member's adjusted taxable income (as defined under section 163(j)). Regardless of whether a taxpayer computes the interest limitation under the proportionate share approach or using the ten percent alternative, any disallowed interest expense could be carried forward indefinitely. A member of a financial reporting group that is subject to the proposal would continue to be subject to the application of section 163(j). Thus, the amount of interest expense disallowed for a taxable year of a taxpayer that is subject to both interest expense disallowance provisions would be determined based on whichever of the two provisions imposes the lower limitation. A member of a financial reporting group may also be subject to the new undertaxed profits rule. (See [Adopt the Undertaxed Profits Rule](#) in this volume for a description)

Each U.S. subgroup of a financial reporting group would be treated as a single member of the financial reporting group for purposes of applying the proposal (except for purposes of applying the ten percent alternative). For this purpose, a U.S. subgroup is comprised of any U.S. entity that is not owned directly or indirectly by another U.S. entity, and all members (domestic or

foreign) that are owned directly or indirectly by such entity. If a member of a U.S. subgroup owns stock in one or more foreign corporations, the proposal would apply before the application of section 265, which generally disallows a deduction for amounts allocable to tax-exempt income. Under the Administration's proposals, tax-exempt income would include dividends from a foreign corporation eligible for a section 245A deduction and a global intangible low-taxed income (GILTI) inclusion eligible for a section 250 deduction. (See [Revise the Global Minimum Tax Regime, Limit Inversions, and Make Related Reforms](#) in this volume.)

The proposal would not apply to financial services entities, and such entities would be excluded from the financial reporting group for purposes of applying the proposal to other members of the financial reporting group. The proposal also would not apply to financial reporting groups that would otherwise report less than \$5 million of net interest expense, in the aggregate, on one or more U.S. income tax returns for a taxable year.

The Secretary would be granted authority to promulgate any regulations necessary to carry out the purposes of the proposal, including (a) coordinating the application of the proposal with other interest deductibility rules, (b) defining interest and financial services entities, (c) permitting financial reporting groups to apply the proportionate share approach using the group's net interest expense for U.S. tax purposes rather than net interest expense reported in the group's financial statements, (d) providing for the treatment of pass-through entities, (e) providing adjustments to the application of the proposal to address differences in functional currency of members, (f) if a U.S. subgroup has multiple U.S. entities that are not all members of a single U.S. consolidated group for U.S. tax purposes, providing for the allocation of the U.S. subgroup's excess net interest expense for U.S. tax purposes among the members of the U.S. subgroup; (g) allowing or requiring the adjustment of amounts reported on applicable financial Statements, including by increasing a member's reported net business interest expense under rules similar to those that apply for disallowed interest expense; and (h) providing rules to address structures with a principal purpose to limit application of the proposal. In addition, if a financial reporting group does not prepare financial statements under U.S. GAAP or IFRS, it is expected that regulations generally would allow the use of financial statements prepared under other jurisdictions' generally accepted accounting principles in appropriate circumstances.

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

## **CONFORM SCOPE OF PORTFOLIO INTEREST EXCLUSION FOR 10-PERCENT SHAREHOLDERS TO OTHER TAX RULES**

### **Current Law**

No tax is generally imposed on portfolio interest received by a foreign person. Portfolio interest is any U.S.-source, non-effectively connected interest paid on an obligation that is in registered form and that would otherwise be taxable to a foreign owner of the obligation.

Interest does not qualify as portfolio interest if an exclusion applies. One particular exclusion applies if the holder of the obligation is a “10-percent shareholder” of the issuer at the time the interest is received. For an obligation issued by a corporation, a 10-percent shareholder is any person who owns 10 percent or more of the total combined voting power of all classes of stock of such corporation entitled to vote. In the case of an obligation issued by a partnership, a 10-percent shareholder is any person who owns 10 percent or more of the capital or profits interest in such partnership.

The Tax Cuts and Jobs Act of 2017 modified the definition of “United States shareholder” for income tax purposes to mean a U.S. person who owns or is considered to own 10 percent or more of the total combined voting power of all classes of stock of a foreign corporation or 10 percent or more of the total value of shares of all classes of stock of such corporation. Prior to the enactment of the Tax Cuts and Jobs Act of 2017, the definition of “United States shareholder” looked only to the voting power of the shareholder.

### **Reasons for Change**

Taxpayers are often able to avoid (or attempt to avoid) being classified as a 10-percent shareholder by limiting their technical voting power in the corporation to under 10 percent, while retaining a substantial interest in the total value of shares of all classes of stock in the corporation. Modifying the definition of 10-percent shareholder to take into account the value of stock owned would prevent gaming of this definition. Moreover, it would promote uniformity by aligning the 10-percent shareholder definition for portfolio interest purposes with the definition of United States shareholder.

### **Proposal**

The proposal would modify the definition of a 10-percent shareholder, in the case of interest paid on an obligation issued by a corporation, to mean any person who owns 10 percent or more of the total combined voting power of all classes of stock of such corporation entitled to vote or 10 percent of the total value of shares of all classes of stock of such corporation.

The proposal would apply to payments of U.S.-source interest made on debt instruments issued (including a deemed issuance) on or after the date that is 60 days after enactment.

## **TREAT PAYMENTS SUBSTITUTING FOR PARTNERSHIP EFFECTIVELY CONNECTED INCOME AS U.S. SOURCE DIVIDENDS**

### **Current Law**

A foreign taxpayer that invests in a U.S. partnership with income effectively connected to the conduct of a trade or business (ECI) is required to file a U.S. tax return to report that income and pay tax on it. Some or all of the gain on the sale of an interest in a partnership that is engaged in the conduct of a U.S. trade or business may be treated as ECI by reference to a deemed sale of the partnership's assets, and tax is required to be withheld on that gain.

For certain purposes, including the U.S. withholding tax rules applicable to foreign persons, a dividend equivalent is treated as a dividend from U.S. sources. A dividend equivalent is any substitute dividend made pursuant to a securities lending or a sale-repurchase transaction that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States. Any payment made under a specified notional principal contract, or made under an equity-linked instrument that meets certain criteria, that directly or indirectly is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States also is treated as a dividend equivalent.

In the case of a dividend equivalent payment made by a foreign person to a foreign person, the jurisdiction of the foreign person making the payment may not treat the payment as a U.S. source dividend subject to U.S. taxation. As a result, the foreign person making the payment may be subject to different and potentially conflicting obligations under U.S. law and foreign law.

### **Reasons for Change**

Foreign taxpayers may take the position that the rules requiring reporting and payment of tax on investments in U.S. partnerships do not apply if the foreign taxpayer acquires an economic interest in a publicly traded partnership with ECI through a derivative financial instrument, such as a total return swap, and that the payments on the financial instrument that are received by the foreign taxpayer are foreign source payments. Foreign taxpayers may also take the position that the rules requiring withholding on dividend equivalent payments do not apply to payments on the financial instrument or apply only to a small portion of those payments. As a result, taxpayers can readily avoid the imposition of U.S. tax on ECI from an investment in a partnership with a U.S. trade or business.

### **Proposal**

The proposal would treat the portion of a payment on a derivative financial instrument (including a securities loan or sale-and-repurchase agreement) that is contingent on income or gain from a publicly traded partnership or other partnership specified by the Secretary as a dividend equivalent, to the extent that the related income or gain would have been treated as ECI if the taxpayer held the underlying partnership interest.

The Secretary would have authority to prescribe such regulations or other guidance as may be necessary or appropriate to carry out the purposes of, and prevent the avoidance of, this section, including with respect to payments made between foreign persons.

No inference is intended as to the application of current law to derivative transactions on interests in partnerships with ECI.

The proposal would be effective for taxable years starting December 31, 2024.

## **EXPAND ACCESS TO RETROACTIVE QUALIFIED ELECTING FUND ELECTIONS**

### **Current Law**

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

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

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

### **Reasons for Change**

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

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

Additionally, there are large individual and administrative costs under current law for the existing special consent procedure. The existing procedure requires a taxpayer to file a ruling

request with the IRS and pay a user fee that is currently several thousand dollars. The IRS receives many requests for consent, which result in the use of IRS time and resources to determine whether consent should be granted and, if so, to issue the private letter ruling. In many cases, allowing the taxpayer to make a retroactive QEF election would be consistent with the proper administration of the law and would promote tax compliance, but the IRS must deny the request because the taxpayer does not qualify for relief under the special consent procedure.

To encourage more taxpayers to make QEF elections, improve taxpayer disclosure, and relieve the costs and burdens that current law imposes on both taxpayers and the IRS, retroactive QEF elections should be permitted for a broader range of circumstances through changes to the statute that expand regulatory authority. For example, the IRS should have authority to allow a retroactive QEF election after the first year of ownership of a PFIC in appropriate cases that promote these goals even if the taxpayer cannot demonstrate a reasonable belief that the company was not a PFIC and cannot satisfy the special consent requirements.

### **Proposal**

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

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

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

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

## **REFORM TAXATION OF FOREIGN FOSSIL FUEL INCOME**

### **Current Law**

Under the global intangible low-taxed income (GILTI) rules, foreign oil and gas extraction income (FOGEI) of a controlled foreign corporation (CFC) is excluded from tested income, whereas foreign oil related income (FORI) is included. In addition, FOGEI and FORI earned by a CFC are not part of the CFC's Subpart F income. Therefore, FOGEI earned through CFCs may be eligible for a deduction under section 245A when repatriated and thus is generally exempt from U.S. taxation. In contrast, both FOGEI and FORI earned directly through a foreign branch (including a disregarded entity) are subject to full U.S. taxation, subject to allowable foreign tax credits (FTCs).

Subject to certain limitations, a taxpayer may claim a credit against its U.S. income tax liability for income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or possession of the United States. Under Treasury regulations, a foreign levy is a tax if it requires a compulsory payment pursuant to the authority of a foreign government to levy taxes. A foreign levy is not a tax to the extent a person subject to the levy receives a specific economic benefit from the foreign country in exchange for the payment (e.g., a concession to extract government-owned petroleum).

A taxpayer that is subject to a foreign levy and who also receives a specific economic benefit from the foreign country (a dual capacity taxpayer) must establish the amount that is paid pursuant to the distinct element of the foreign levy that is a tax. The dual capacity taxpayer cannot claim FTCs with respect to amounts paid in exchange for the specific economic benefit. Treasury regulations provide a safe harbor for determining the qualifying portion of the levy based on the generally applicable rate of tax under the jurisdiction's income tax. However, taxpayers may use the facts and circumstances method for determining the qualifying portion of the levy rather than the safe harbor.

### **Reasons for Change**

FTCs are intended to mitigate double taxation of income by the United States and a foreign government. When a payment is made to a foreign government in exchange for a specific economic benefit, there is no double taxation. Current law recognizes the distinction between a payment of creditable taxes and a payment in exchange for a specific economic benefit but may fail to achieve the appropriate split between the two (e.g., when a foreign jurisdiction does not charge royalties but imposes a levy only on oil and gas income, or imposes a higher levy on oil and gas income as compared to other income). The safe harbor method reflects the view that the higher effective rate of the nominal foreign tax is appropriately characterized as compensating the foreign government in its capacity as the owner of the minerals in place, rather than in its role as tax collector. However, many dual capacity taxpayers subject to alternative tax regimes use the facts and circumstances method for determining the qualifying portion of the levy and claim FTCs for a much larger amount than would be creditable under the safe harbor method. Consequently, many oil and gas producers are able to claim a credit against their U.S. income tax liability for high levies imposed by foreign governments that effectively constitute royalty

equivalents (instead of income taxes), while other U.S. businesses (not in the oil/gas sector) in those same countries pay a much lower income tax rate (and therefore are only eligible for the correspondingly lower FTCs in the United States).

Foreign hydrocarbon income should not be eligible for preferential tax treatment relative to other industries because of the negative externalities associated with such industry and the Administration's overall goal of promoting clean energy.

### **Proposal**

The proposal would repeal the exemption from GILTI for FOGEI. The definition of FOGEI and FORI would also be amended to include income derived from shale oil and tar sands activity.

In the case of a dual capacity taxpayer, the proposal would limit the amount of a levy that would qualify as a creditable foreign tax to the amount of tax that the dual capacity taxpayer would have paid to the foreign government if it were a non-dual capacity taxpayer. Thus, the proposal would codify the safe harbor included in the current Treasury regulations for determining the portion of the levy that is paid in exchange for a specific economic benefit, and would make the safe harbor the sole method for determining the creditable portion of the levy. The aspect of the proposal that would determine the amount of a foreign levy paid by a dual-capacity taxpayer that qualifies as a creditable tax would yield to U.S. treaty obligations that explicitly allow a credit for taxes paid or accrued on certain oil or gas income.

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

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

### **Current Law**

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

### **Reasons for Change**

The proposal creates a tax incentive to bring offshore jobs and investment back to the U.S. Reducing the tax benefits from moving U.S. jobs offshore will increase incentives to keep those jobs at home.

### **Proposal**

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

In addition, to reduce tax benefits associated with U.S. companies moving jobs outside of the United States, the proposal would disallow deductions for expenses paid or incurred in connection with offshoring a U.S. trade or business. For this purpose, offshoring a U.S. trade or business means reducing or eliminating a trade, business, or line of business currently conducted inside the United States and starting up, expanding, or otherwise moving the same trade or business outside the United States, to the extent that this action results in a loss of U.S. jobs. In addition, no deduction would be allowed against a U.S. shareholder's global intangible low-taxed income or Subpart F income inclusions for any expenses paid or incurred in connection with moving a U.S. trade or business outside the United States.

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

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

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

## **SUPPORT HOUSING AND URBAN DEVELOPMENT**

### **MAKE PERMANENT THE NEW MARKETS TAX CREDIT AND FORMALIZE ALLOCATION INCENTIVES FOR INVESTING IN AREAS OF HIGHER DISTRESS**

#### **Current Law**

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

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

For calendar years 2010 through 2019, the national credit limitation amount per year was \$3.5 billion, and for 2020 through 2025 the annual amount is \$5 billion. No new investment allocation authority is provided beyond 2025. The CDFI Fund allocates credit amounts, subject to the total national credit limitation, among CDEs based on a competitive application process. This application process currently considers the CDE's business and capitalization strategy, management capacity and projected community impact, including their level of commitment to invest in areas of higher distress beyond the minimum low-income community definition outlined in the statute. Additionally, the allocation process provides priority to applications that meet two statutorily designated priorities: (a) applicants with a record of having successfully provided capital or technical assistance to disadvantaged businesses or communities and (b) applicants who intend to use their NMTC allocation to invest in unrelated businesses.

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

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

### **Reasons for Change**

Permanent extension of the NMTC would allow CDEs to continue to generate investments in low-income communities. The extension would also create greater certainty for investment planning purposes. Adding a third statutory priority would create an incentive for CDEs to commit to targeting populations, geographies, and businesses experiencing deep economic distress during the competitive allocation process and ensures communities most in need are served by NMTCs.

### **Proposal**

The proposal would extend the NMTC permanently, with a new allocation for each year after 2025. The annual amount would be \$5 billion, indexed for inflation after 2026. The proposal would also add a third allocation priority to favor CDEs that intend to concentrate their qualified low-income community investments on populations, geographies and/or businesses that are identified by the Secretary as having significantly deeper levels of economic distress beyond the baseline requirements for eligible NMTC low-income communities.

The proposal would be effective after the date of enactment.

## **PROVIDE A NEIGHBORHOOD HOMES CREDIT**

### **Current Law**

There are no Federal tax provisions that directly support building or renovating affordable owner-occupied housing or that cover a development or financing gap for such housing. The low-income housing credit supports construction and rehabilitation of affordable housing for low-income renters. The mortgage interest deduction, tax-exempt housing bonds, and mortgage credit certificates assist homeowners by reducing the after-tax costs of their mortgage payments, but this support is not directed at addressing development cost gaps for affordable owner-occupied housing.

### **Reasons for Change**

In neighborhoods where homes are in poor condition, property values are often too low to support new construction or substantial renovation of existing properties, meaning that it costs more to construct or renovate the homes than these homes are worth. A subsidy for home builders and homeowners seeking to rehabilitate these homes can encourage residential development in these neighborhoods. If targeted at homes sold to (or being rehabilitated by) owner-occupants, the subsidy can encourage further improvements to these areas, as owner-occupants generally have greater long-term interest in their neighborhoods than renters.

### **Proposal**

The proposal would create a new allocated tax credit, the neighborhood homes credit (NHC), to encourage (a) new construction for sale, (b) substantial rehabilitation for sale, and (c) substantial rehabilitation by existing homeowners who will remain in their communities. The credit would be allocated through each State's Neighborhood Homes Credit Agency (NHCA) for projects meeting criteria described below.

### **Role of NHCAs**

Each State would create or designate an NHCA to allocate potential NHCs to project sponsors, – i.e., individuals or entities that organize the project. Sponsors seeking NHCs would apply to their State NHCA. The NHCAs would evaluate the applications and choose those deemed best suited to achieving the goals of the tax incentive. Furthermore, the NHCA would be responsible for monitoring compliance with all provisions governing NHCs and for reporting violations to the Internal Revenue Service. NHCAs would also set standards for developer fees, building quality (including all local criteria for habitability and safety), and development costs.

### **Allocation to States, U.S. territories, and the District of Columbia (collectively, States)**

Each State would have a specified amount of potential NHCs to allocate each calendar year. For 2025 each State could allocate the greater of \$8 million or the product of \$6 times the State's population. The amounts would be indexed for inflation for subsequent years using the producer

price index for final demand construction. States would be able to carry forward any unallocated potential NHCs for up to three years.

#### Eligibility criteria for NHC residences

Sponsors would be eligible for NHCs only if the residences they are constructing or rehabilitating meet all the following criteria:

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

#### Eligibility criteria for NHC neighborhoods

An NHC neighborhood is a census tract that meets at least one of the following criteria:

1. Has all of these characteristics: (1a) median family income not exceeding 80 percent of the area/State median income, (1b) a poverty rate not less than 130 percent of the area/State poverty rate, and (1c) a median value for owner-occupied homes not exceeding the area/State median value;
2. Has all of these characteristics: (2a) median family income not exceeding area/State median income, (2b) is located in a city with a poverty rate of at least 150 percent of the area/State poverty rate and a population of at least 50,000, and (2c) a median value for owner-occupied homes not exceeding 80 percent of the area/State median value;
3. Has all of these characteristics: (3a) median family income not exceeding area/State median income, (3b) is located in a non-metropolitan county, and (3c) has been designated as an NHC neighborhood by an NHCA; or
4. Is located in a disaster area.

#### Eligibility criteria for qualifying owners

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

### Determination of credit amount

In general, the credit amount would increase as development costs increase and decrease as sales proceeds (or owner payments, in the case of rehabilitation for current homeowners) increase. The credit would be limited to no more than the lesser of 35 percent of development costs and 28 percent of the national median sales price for new homes. In the case of construction or rehabilitation for sale, the maximum amount of NHC would be 87 percent of development costs minus 80 percent of sales proceeds. In the case of rehabilitation for the current resident homeowner, the maximum amount of NHC would equal 87 percent of development costs minus 80 percent of owner payments. In all cases the maximum amount of NHC would be reduced by 7 percent of the excess of development costs over 250 percent of area median family income. No credit would be allowed for projects in which development costs exceed 500 percent of area median family income. (An appropriately adjusted phase out would apply in the case of residences with more than one dwelling unit.)

Under the proposed NHC formula, a taxpayer would always be better off obtaining a higher sales price, and a small increase in sales price would not trigger a disproportionate loss of credits. Moreover, the proposal would maintain appropriate developer incentives regarding marginal improvements to the home during construction or rehabilitation.

In determining the credit amount, construction costs would be taken into account only to the extent they are incurred after a NHCA has allocated potential NHCs to the project; and acquisition costs for land and buildings would be taken into account only to the extent they are incurred not more than three years prior to such an allocation.

In the case of a rehabilitation of an owner-occupied residence, the credit would not exceed the lesser of \$50,000 and 50 percent of rehabilitation costs. Similar to the case of a home sale, a taxpayer would always be better off obtaining a higher owner payment for a home rehabilitation, and a small increase in owner payments would not trigger a disproportionate loss of credits.

The amount of the taxpayer's NHC would reduce the amounts that would otherwise be included in the taxpayer's basis of a home or in any deductible construction or rehabilitation expenses.

### Return of unused credits

If any credits allocated to a project are unused five years after the NHCA allocation, or if the person holding the potential credits returns them to the NHCA before that five-year anniversary, the potential credits are included in the pool of potential credits for the NHCA to re-allocate in the year after the return. As with potential credits that the statute annually makes available to the NHCA for allocation, these returned credits may be carried forward for up to three years.

### Timing of owner occupancy

A taxpayer becomes entitled to NHCs only when construction and inspection are complete and the home is occupied by an NHC-qualified owner. If, within five years of the last day of the calendar year in which the taxpayer became entitled to the NHCs, the purchasing or

rehabilitating owner-occupant sells or rents the home, there may be NHC-related financial consequences to the owner-occupant. In the case of a sale, any gain from the sale would have to be paid to the NHCA. The Secretary, however, would have authority to identify in published guidance situations in which a smaller payment to the NHCA would be appropriate. In the case of renting during the five-year period, expenses with respect to the home would not be deductible in determining the owner's Federal income taxes.

#### Implementation and reporting

The Secretary would be given authority to prescribe rules to implement this provision. NHCAs would be required to submit an annual report to the Secretary specifying the amount of potential NHCs allocated to each project for the previous year, information on each NHC residence completed in the previous year, and such other information as the Secretary may require.

Area median family income shall be determined by the Secretary in a manner consistent with determinations of area median family income under section 8 of the United States Housing Act of 1937 (or, if such program is terminated, under such program as in effect immediately before such termination). Determinations under the preceding sentence shall include adjustments for family size. Subsections (g) and (h) of section 7872 shall not apply in determining the income of individuals under this subparagraph.

The first calendar year in which the proposal would make potential NHCs available for NHCAs to allocate would be 2025. In all other respects, the proposal would be effective for taxable years ending after December 31, 2024.

## **EXPAND AND ENHANCE THE LOW-INCOME HOUSING CREDIT**

### **Current Law**

Low-income housing credits (LIHTCs) incentivize and subsidize the construction and rehabilitation of affordable rental housing for low-income tenants. Building owners earn LIHTCs by constructing and operating a low-income housing project in conformity with the LIHTC requirements (including limitations on tenant income, restrictions on gross rents, and periodically assessed habitability). For each of 10 years, the owner receives LIHTCs for a building in such a project. The number of LIHTCs received each year may not exceed the product of: (a) the depreciable cost of the entire building (eligible basis); (b) the portion of the building that consists of low-income units; and (c) a credit rate. Credit rates are generally either 4 or 9 percent.

In the case of the 9 percent credit rate, the credits for each of the 10 years may not exceed the housing credit dollar amount (HCDA) that a State or local housing credit agency (HCA) previously allocated to the taxpayer. Each State, including the District of Columbia and territories of the United States, receives a pool of new HCDAs to allocate every year. (For 2023, each State received \$2.75 per capita in new potential credits to allocate, subject to a minimum of \$3,185,000 for smaller States.) The total ceiling available for a State to allocate each year also includes unused or returned HCDAs from prior years. Because the HCAs' HCDA pools are almost always oversubscribed, potential developers of LIHTC projects compete for allocations by offering project proposals to the relevant HCA. Each HCA must have a Qualified Allocation Plan (QAP) to guide its allocations.

A building can be eligible to earn credits at a 4 percent rate if the building and the land on which it sits are financed at least 50 percent by private activity bonds (PABs) that are subject to a State's volume cap. (A State's volume cap is the annual limit on the PABs that the State may issue for all purposes, including for qualified residential rental projects that can earn LIHTCs.) By focusing its volume cap on financing qualified residential rental projects, in combination with allocating HCDAs, a State can more than double the number of LIHTC-supported affordable rental units that it could achieve with its HCDAs alone.

Qualifying buildings may not earn LIHTCs unless they are subject to an extended low-income housing commitment: an agreement that requires the building to maintain affordability and habitability and binds all current and subsequent owners for a period of at least 30 years. In addition to an owner's ability to transfer a LIHTC building subject to that commitment, current law contains two particular mechanisms for original owners to sever their connection to the building and yet to leave affordability and habitability requirements intact.

First, after the 14<sup>th</sup> year of the extended-use period, the owner can ask the HCA to provide a qualified contract, under which the owner can sell the building. In general, a qualified contract requires the buyer to continue to maintain the building's affordability and habitability at a purchase price that includes a fair market value (FMV) component for the non-low-income portion of the building plus a component for the low-income portion of the building that is at or above an amount based on a statutory formula. If, however, the HCA fails to provide such an

offer within a year of the owner's request, the extended use period terminates, as do the affordability and habitability requirements.

Second, current law contains a safe harbor for a "right of first refusal" (ROFR) to facilitate a sale to tenants (or a tenant group), to a resident management corporation, to a qualified nonprofit organization, or to a government agency. The purchase under such a contract would occur after the 15<sup>th</sup> year for at least the outstanding debt incurred more than five years before the sale, plus Federal income tax triggered by the sale. These purchasers would remain subject to the requirements to maintain affordability and habitability. Under the safe harbor, no Federal income tax benefit with respect to the building is denied to the original owners.

### **Reasons for Change**

The United States faces a housing supply gap. Increasing the supply of housing will mean more affordable rents and more attainable homeownership for Americans in every community. The LIHTC incentive is the Federal Government's largest source of support for the construction and rehabilitation of rental housing for low-income tenants. Increasing annual HCDAs can help increase housing supply and reduce the gap. Reducing the PAB financing requirement will further expand the reach of the credit to more projects and thereby further support housing supply.

In addition, the qualified contract provision and ROFR provisions no longer function as intended. First, the statutorily determined purchase price in a qualified contract is generally higher than what buyers are willing to pay for a building subject to affordability and habitability requirements. As a result, HCAs often fail to provide a buyer that will accept the statutory terms, and so the qualified contract provision serves to reduce the duration of the affordability and habitability requirements. Second, some LIHTC investors have imposed hurdles on the use of ROFRs, allowing LIHTC projects to be too easily converted to market-rate housing.

### **Proposal**

The proposal would make the following changes to current law:

#### **Increase annual HCDAs.**

For 2025, each State would receive \$4.37 per capita in new potential credits for allocation, subject to a minimum of \$5,039,154 for smaller States. For 2026, the per capita and State minimum amounts would be \$4.99 and \$5,754,271, respectively. For 2027 and subsequent years, these amounts would be the amounts for the prior year, indexed for inflation as under current law.

#### **Reduce the 50 percent PAB financing requirement.**

A building would be eligible to earn LIHTCs on the basis of 25 percent (rather than 50 percent) PAB financing of the building and land. This change would apply to buildings placed in service

in taxable years beginning after December 31, 2024.

Repeal the qualified contract provision.

The proposal would repeal the qualified contract provision, meaning that an owner could no longer end the extended use period for a building by requesting—and not receiving—a qualified contract to purchase the building.

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

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

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

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

The safe harbor applicable under current law to a ROFR would instead be applicable to options to buy. Only persons that are eligible under current law to hold a right of first refusal could be the holder(s) of the option. To be eligible for the safe harbor, the right to purchase would have to cover both the building and assets required for continued operation as affordable rental housing and/or remaining partnership interests in the building. In addition, the right to purchase would have to be exercisable regardless of the approval or non-approval of the current owner or related persons.

Finally, the purchase price of the LIHTC building would have to be at least the debt incurred more than 5 years before the date of sale that is secured by the building. The contractual purchase price of partnership interest(s) would have to be at least the partnership's ratable share of the amount described in the preceding sentence.

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

## **MODIFY ENERGY TAXES**

### **ELIMINATE FOSSIL FUEL TAX PREFERENCES**

#### **Current Law**

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

#### **Credit for enhanced oil recovery**

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

#### **Credit for oil and natural gas produced from marginal wells**

In addition, the general business credit includes a credit for crude oil and natural gas produced from marginal wells. For taxable years beginning after 2005, the full potential credit rate is determined by the annual inflation adjustment applied to a starting credit rate of \$3.00 per barrel of oil and \$0.50 per 1,000 cubic feet of natural gas. The credit per well is limited to 1,095 barrels of oil or barrel-of-oil equivalents per year. The credit rates for crude oil and natural gas are phased out for a taxable year if the reference price exceeds the applicable thresholds. The crude oil phase-out range and the applicable threshold at which the phase-out begins in 2023 are \$4.50 and \$22.49 respectively. The natural gas phase-out range and the applicable threshold at which the phase-out begins are \$0.50 and \$2.50. Both sets of rates are adjusted annually for inflation. In 2023, the credits for both natural gas and oil were completely phased out.

#### **Expensing of intangible drilling costs (IDCs)**

IDCs include all expenditures made by an operator for wages, fuel, repairs, hauling, supplies, and other expenses incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and natural gas. Generally, IDCs do not include expenses for items which have a salvage value or items related to the acquisition of the property. An operator who pays or incurs IDCs in the development of an oil or natural gas property located in the United States, including certain wells drilled offshore, may elect either to expense or capitalize those costs. If a taxpayer elects to expense IDCs, the amount of the IDCs is deductible as an expense in the taxable year that the cost is paid or incurred. For any particular taxable year, a taxpayer may deduct some portion of its IDCs and capitalize the rest under the provision.

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

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

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

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

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

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

### Two-year amortization of independent producers' geological and geophysical expenditures

Geological and geophysical expenditures are costs incurred for the purpose of obtaining and accumulating data that will serve as the basis for the acquisition and retention of mineral properties. The amortization period for geological and geophysical expenditures incurred in connection with oil and natural gas exploration in the United States is two years for independent producers and seven years for major integrated oil companies.

### Expensing of mine exploration and development costs

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

### Percentage depletion for hard mineral fossil fuels

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

### Capital gains treatment for royalties

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

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

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

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

Crudes such as those that are produced from bituminous deposits as well as kerogen-rich rock are not treated as crude oil or petroleum products for purposes of the OSTLF and Superfund taxes. The rate of tax on crude is the sum of the \$0.09 per barrel financing rate dedicated to the OSTLF and the \$0.164 per barrel financing rate dedicated to the Superfund. The tax is imposed

on crude oil received at a United States refinery, and on petroleum products entered into the United States for consumption, use, or warehousing.

### Amortization of air pollution control facilities

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

### Reasons for Change

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

### Proposal

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

Unless otherwise specified, the proposal provisions would be effective for taxable years beginning after December 31, 2024. In the case of royalties, the proposal provision would be effective for amounts realized in taxable years beginning after December 31, 2024, regardless of when the property generating these royalties was acquired.

The repeal of the exemption from the corporate income tax for publicly traded partnerships with qualifying income and gains from activities relating to fossil fuels would be effective for taxable years beginning after December 31, 2029.

## **ELIMINATE DRAWBACKS ON PETROLEUM TAXES THAT FINANCE THE OIL SPILL LIABILITY TRUST FUND AND SUPERFUND**

### **Current Law**

An excise tax is imposed on: (a) crude oil received at a U.S. refinery; (b) imported petroleum products (including crude oil) entered into the United States for consumption, use, or warehousing; and (c) any domestically produced crude oil that is used (other than on the premises where produced for extracting oil or natural gas) in or exported<sup>16</sup> from the United States if, before such use or exportation, no taxes were imposed on the crude oil. The rate of tax is the sum of (a) the Hazardous Superfund financing rate of 16.4 cents per barrel, adjusted annually for inflation and (b) the Oil Spill Liability Trust Fund financing rate of 9 cents per barrel.

The revenues from the Hazardous Superfund financing rate are dedicated to the Hazardous Substance Superfund (Superfund). Amounts in the Superfund are available for expenditures incurred in connection with releases or threats of releases of hazardous substances into the environment under specified provisions of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (as amended).

The revenues from the Oil Spill Liability Trust Fund (OSLTF) financing rate are dedicated to the OSLTF to pay costs associated with oil removal and damages resulting from oil spills, as well as to provide annual funding to certain agencies for a wide range of oil pollution prevention and response programs, including research and development. In the case of an oil spill, the OSLTF makes it possible for the Federal Government to pay for removal costs up front, and then seek full reimbursement from the responsible parties.

U.S. Code Title 19 (Customs Duties), section 1313 – Drawbacks and Refunds has been interpreted to allow drawback of the tax (a rebate of taxes paid when goods are imported and then exported again) when products are exported – even if the exports are exempt from the tax.

### **Reasons for Change**

The magnitude of the Federal response to recent disasters has reinforced the importance of the OSLTF and the need to maintain a sufficient balance in the fund, particularly in order to accommodate spills of national significance. The Superfund provides critical financing to remedy damages caused by releases of hazardous substances.

The drawback of the petroleum tax is granted when the product is exported even though there is no concomitant reduction in the risk of an oil spill or release of a hazardous substance. A

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<sup>16</sup> The court in *Trafigura Trading, LLC v. United States*, 29 F.4th 286 (5th Cir. 2022), held that imposing the IRC 4611 oil spill liability tax on crude oil exported from the United States violates the Export Clause of the U.S. Constitution. Because another court has interpreted drawback to be available even based on an export not subject to tax, untaxed exports could be the basis for section 4611 drawback claims on imported petroleum products. Thus, imported petroleum products would be introduced to the U.S. market effectively free of the section 4611 taxes paid by all domestic production consumed domestically.

prohibition on the drawbacks of the tax will strengthen the finances of the OSLTF and Superfund and remove an incentive to export crude and like products.

**Proposal**

The eligibility of the petroleum taxes dedicated to the OSLTF and Superfund for drawback would be eliminated.

The proposal would be effective after December 31, 2024.

## **IMPOSE DIGITAL ASSET MINING ENERGY EXCISE TAX**

### **Current Law**

Current law does not provide tax rules specifically addressing digital assets, with the exception of certain rules relating to broker reporting and reporting of cash transactions.

### **Reasons for Change**

Digital asset mining is a process for validating transactions among holders of digital assets to record and transfer cryptographically secured assets on a distributed ledger by, for example, using high-powered computers to perform calculations to select the validator.

The computational effort involved in mining can be substantial and can therefore require a correspondingly large amount of energy. The increase in energy consumption attributable to the growth of digital asset mining has negative environmental effects and can have environmental justice implications as well as increase energy prices for those that share an electricity grid with digital asset miners. Digital asset mining also creates uncertainty and risks to local utilities and communities, as mining activity is highly variable and highly mobile.

An excise tax on electricity usage by digital asset miners could reduce mining activity along with its associated environmental impacts and other harms.

### **Proposal**

Any firm using computing resources, whether owned by the firm or leased from others, to mine digital assets would be subject to an excise tax equal to 30 percent of the costs of electricity used in digital asset mining.

Firms engaged in digital asset mining would be required to report the amount and type of electricity used as well as the value of that electricity, if purchased externally. Firms that lease computational capacity would be required to report the value of the electricity used by the lessor firm attributable to the leased capacity, which would serve as the tax base. Firms that produce or acquire power off-grid, for example by using the output of a particular electricity generating plant, would be subject to an excise tax equal to 30 percent of estimated electricity costs.

Except as otherwise provided by the Secretary, the term “digital asset” means any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary.

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

## **STRENGTHEN TAXATION OF HIGH-INCOME TAXPAYERS**

### **APPLY THE NET INVESTMENT INCOME TAX TO PASS-THROUGH BUSINESS INCOME OF HIGH-INCOME TAXPAYERS**

#### **Current Law**

Individuals with modified adjusted gross incomes over a threshold amount are subject to a 3.8 percent tax on net investment income. The threshold is \$200,000 for single and head of household returns and \$250,000 for joint returns. Net investment income generally includes: (a) interest, dividends, rents, annuities, and royalties, other than such income derived in the ordinary course of a trade or business; (b) income derived from a trade or business in which the taxpayer does not materially participate; (c) income from a business of trading in financial instruments or commodities; and (d) net gain from the disposition of property other than property held in a trade or business in which the taxpayer materially participates. The net investment income tax (NIIT) does not apply to self-employment earnings.

Self-employment earnings and wages are subject to employment taxes under the Self-Employment Contributions Act (SECA) and the Federal Insurance Contributions Act (FICA), respectively. Both SECA and FICA taxes apply at a rate of 12.4 percent for social security tax on employment earnings (capped at \$168,600 in 2024) and at a rate of 2.9 percent for Medicare tax on all employment earnings (not subject to an earnings cap). An additional 0.9 percent Medicare tax is imposed on self-employment earnings and wages of high-income taxpayers, above the same NIIT thresholds of \$200,000 for single and head of household filers and \$250,000 for joint filers, thus bringing the combined rate of Medicare tax to 3.8 percent for these taxpayers.

General partners and sole proprietors pay SECA tax on the full amount of their net trade or business income, subject to certain exceptions. Section 1402(a)(13) of the Internal Revenue Code provides that the distributive share of partnership income or loss of a limited partner is excluded from SECA tax, although limited partners are subject to SECA tax on their section 707(c) guaranteed payments from the partnership that are for services they provide to, or on behalf of, the partnership. Because the statutory exclusion only refers to limited partners, questions have arisen as to the meaning of this term and whether the limited partner exclusion might be applicable to limited liability company (LLC) members. Some partners who claim to be limited partner members may more accurately be described as general partners who would be subject to SECA.

S corporation shareholders are not subject to SECA tax. However, tax law requires that those shareholders who are owner-employees pay themselves “reasonable compensation” for services provided, on which they pay FICA tax like any other employee. Nonwage distributions to shareholders of S corporations are not subject to either FICA or SECA taxes.

#### **Reasons for Change**

Active owners of pass-through businesses, including S corporations and partnerships, are treated differently for purposes of the NIIT, SECA tax, and FICA tax according to the legal form of their

ownership and the legal form of the payment that they receive. While general partners and sole proprietors pay SECA tax on earnings from their businesses, S-corporation owner-employees pay employment taxes on only a portion of their earnings, and limited partners often pay little or no SECA tax. Although the NIIT reflects an intention to impose the 3.8 percent tax on both earned and unearned income of high-income taxpayers, certain income, specifically distributions to S corporation shareholder-employees and distributions to limited partners who claim the statutory exclusion for limited partners, escape the combined 3.8 percent tax from FICA or SECA and the NIIT.

These inconsistencies in the treatment of pass-through business income are unfair and inefficient. They distort choice of organizational form and provide tax planning opportunities for business owners, particularly those with high incomes, to avoid paying their fair share of taxes.

The current system is also a challenge for the Internal Revenue Service (IRS) to administer. The determination of “reasonable compensation” of S corporation owner-employees generally depends on facts and circumstances and requires a valuation analysis that can be contested by the taxpayer and increases the IRS’s cost of administration and enforcement. Uncertainty surrounding the treatment of limited partners and LLC members who materially participate in their businesses undermines the IRS’s ability to ensure payment of SECA tax and the NIIT.

### **Proposal**

The proposal would expand the NIIT base to ensure that all pass-through business income of high-income taxpayers is subject to either the NIIT or SECA tax.

In order to determine the amount of trade or business income that would be subject to the NIIT under the proposal, the taxpayer would sum (a) ordinary business income derived from S corporations for which the owner materially participates in the trade or business, (b) ordinary business income derived from either limited partnership interests or interests in LLCs that are classified as partnerships to the extent a limited partner or LLC member materially participates in its partnership’s or LLC’s trade or business,<sup>17</sup> and (c) any other trade or business income to the extent that such income is not subject to NIIT or SECA under current law (this sum referred to as the “potential NIIT income”). The additional income that would be subject to the NIIT would be a specified percentage of potential NIIT income. The specified percentage would start at zero and would increase linearly to 100 as adjusted gross income rises from \$400,000 to \$500,000 (\$200,000 to \$250,000 for married taxpayers filing separately). The threshold amounts given in this paragraph would not be indexed for inflation.

Material participation standards would apply to individuals who participate in a business in which they have a direct or indirect ownership interest. Taxpayers are usually considered to materially participate in a business if they are involved in it in a regular, continuous, and substantial way. Often this means they work for the business for at least 500 hours per year. The

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<sup>17</sup> For purposes of clause (b), limited partners and LLC members claiming to be limited partners who provide services and materially participate in their partnerships and LLCs would be subject to the NIIT on their distributive shares of partnership or LLC ordinary income to the extent that this income exceeds certain threshold amounts and is not treated as self-employment income subject to SECA.

statutory exception to SECA tax for limited partners would not exempt a limited partner from the NIIT if the limited partner otherwise materially participated.

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

## **INCREASE THE NET INVESTMENT INCOME TAX RATE AND ADDITIONAL MEDICARE TAX RATE FOR HIGH-INCOME TAXPAYERS**

### **Current Law**

Individuals with modified adjusted gross incomes over a threshold amount are subject to a 3.8 percent tax on net investment income. The threshold is \$200,000 for single and head of household returns, \$250,000 for joint returns, and \$15,200 (for 2024) for estates and trusts. Net investment income generally includes: (a) interest, dividends, rents, annuities, and royalties, other than such income derived in the ordinary course of a trade or business; (b) income derived from a trade or business in which the taxpayer does not materially participate; (c) income from a business of trading in financial instruments or commodities; and (d) net gain from the disposition of property other than property held in a trade or business in which the taxpayer materially participates. The net investment income tax (NIIT) does not apply to self-employment earnings. Proceeds from the NIIT flow into the General Fund of the Treasury.

Self-employment earnings and wages are subject to employment taxes under either the Self-Employment Contributions Act (SECA) or the Federal Insurance Contributions Act (FICA), respectively. Both SECA and FICA taxes apply at a rate of 12.4 percent for social security tax on employment earnings (capped at \$168,600 in 2024) and at a rate of 2.9 percent for Medicare tax on all employment earnings (not subject to a cap). An additional 0.9 percent Medicare tax is imposed on self-employment earnings and wages of high-income taxpayers, above the same NIIT thresholds of \$200,000 for single and head of household filers and \$250,000 for joint filers, thus bringing the combined rate of Medicare tax to 3.8 percent for these taxpayers. The FICA and SECA Medicare taxes flow into the Hospital Insurance Trust Fund (HITF), which finances Medicare Part A.

### **Reasons for Change**

According to current projections from the Medicare trustees, the Hospital Insurance Trust Fund (HITF) will be exhausted in 2031. Increasing the NIIT and additional Medicare tax for high-income taxpayers and devoting NIIT proceeds to the HITF will extend the life of the trust fund.

In addition, the differential treatment of NIIT revenues and the Medicare portion of FICA and SECA taxes, with the former paid into the General Fund of the Treasury and the latter paid into the HITF, is inconsistent with the fact that the taxes are intended for the same purpose.

A previous proposal in this volume, [\*Apply the Net Investment Income Tax to Pass-Through Business Income of High-Income Taxpayers\*](#), would expand the base of the NIIT to ensure all pass-through trade or business income is taxed either through the NIIT or SECA taxes.

### **Proposal**

The proposal would increase the additional Medicare tax rate by 1.2 percentage points for taxpayers with more than \$400,000 of earnings. When combined with current-law tax rates, this

would bring the marginal Medicare tax rate up to 5 percent for earnings above the threshold. The threshold would be indexed for inflation.

The proposal would also increase the NIIT rate by 1.2 percentage points for taxpayers with more than \$400,000 of income, similarly bringing the marginal NIIT rate to 5 percent for investment income above the threshold. Specifically, for taxpayers with positive net investment income, the NIIT would increase by 1.2 percentage points on the lesser of (a) net investment income or (b) the excess, if any, of modified adjusted gross income over \$400,000. The threshold would be indexed for inflation.

Under the proposal, the revenue from the NIIT (that raised under current law and that which would be raised under any proposed expansion) would be directed to the HITF in the same manner as the revenue from the current 3.8 percent tax on earnings and the proposed additional 1.2 percent tax on earnings.

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

## **INCREASE THE TOP MARGINAL INCOME TAX RATE FOR HIGH-INCOME EARNERS**

### **Current Law**

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

For taxable years beginning after December 31, 2023, and before January 1, 2025, the top marginal tax rate applies to taxable income over \$731,200 for married individuals filing a joint return and surviving spouses, \$609,350 for unmarried individuals (other than surviving spouses and head of household filers), \$609,350 for head of household filers, and \$365,600 for married individuals filing a separate return. The tax bracket thresholds are indexed for inflation.

### **Reasons for Change**

Raising the top tax rate for the highest-income taxpayers would raise revenue and increase the progressivity of the tax system.

### **Proposal**

The proposal would increase the top marginal tax rate to 39.6 percent. The top marginal tax rate would apply to taxable income over \$450,000 for married individuals filing a joint return and surviving spouses, \$400,000 for unmarried individuals (other than surviving spouses and head of household filers), \$425,000 for head of household filers, and \$225,000 for married individuals filing a separate return. After 2024, the thresholds would be indexed for inflation using the C-CPI-U, which is used for all current thresholds in the tax rate tables.

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

## **REFORM THE TAXATION OF CAPITAL INCOME**

### **Current Law**

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

### **Reasons for Change**

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

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

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

### **Proposal**

The proposal would make the following changes to current law:

### Tax capital income for high-income earners at ordinary rates

Long-term capital gains and qualified dividends of taxpayers with taxable income of more than \$1 million would be taxed at ordinary rates, with 37 percent generally being the highest rate (40.8 percent including the net investment income tax).<sup>18</sup> The proposal would only apply to the extent that the taxpayer's taxable income exceeds \$1 million (\$500,000 for married filing separately), indexed for inflation after 2024.<sup>19</sup>

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

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

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

Gain on unrealized appreciation also would be recognized by a trust, partnership, or other non-corporate entity that is the owner of property if that property has not been the subject of a recognition event within the prior 90 years. For this purpose, a tacking<sup>20</sup> rule would apply to property received in a nonrecognition event from another such entity. This provision would apply to property held on or after January 1, 1944, that is not subject to a recognition event after December 31, 1943, so that the first recognition event would be deemed to occur on December 31, 2033.

A transfer would be defined under the gift and estate tax provisions and would be valued at the value used for gift or estate tax purposes. However, for purposes of the imposition of this capital gains tax, the following would apply. First, a transferred partial interest generally would be valued at its proportional share of the fair market value of the entire property, provided that this rule would not apply to an interest in a trade or business to the extent that its assets are actively

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<sup>18</sup> A separate proposal would first raise the top ordinary rate to 39.6 percent (43.4 percent including the net investment income tax). An additional proposal would increase the net investment income tax rate by 1.2 percentage points above \$400,000, bringing the marginal net investment income tax rate to 5 percent for investment income above the \$400,000 threshold. Together, the proposals would increase the top marginal rate on long-term capital gains and qualified dividends to 44.6 percent. (See [Increase the Top Marginal Income Tax Rate for High-Income Earners](#) and [Increase the Net Investment Income Tax Rate and Additional Medicare Tax Rate for High-Income Taxpayers](#) in this volume.)

<sup>19</sup> For example, a taxpayer with \$1,100,000 in taxable income of which \$200,000 is preferential capital income would have \$100,000 of capital income taxed at the preferential rate and \$100,000 taxed at ordinary rates.

<sup>20</sup> A tacking rule would give the transferee a holding period that includes the holding period of the transferor.

used in the conduct of that trade or business. Second, transfers of property into, and distributions in kind from a trust, other than a grantor trust that is deemed to be wholly owned and revocable by the donor, would be recognition events, as would transfers of property to, and by, a partnership or other non-corporate entity, if the transfers have the effect of a gift to the transferee. The deemed owner of such a revocable grantor trust would recognize gain on the unrealized appreciation in any asset distributed from the trust to any person other than the deemed owner or the U.S. spouse of the deemed owner, not including distributions made in discharge of an obligation of the deemed owner. All of the unrealized appreciation on assets of such a revocable grantor trust would be realized at the deemed owner's death or at any other time when the trust becomes irrevocable.

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

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

In addition to the above exclusions, the proposal would allow a \$5 million per-donor exclusion from recognition of other unrealized capital gains on property transferred by gift during life. This exclusion would apply only to unrealized appreciation on gifts to the extent that the donor's cumulative total of lifetime gifts exceeds the basic exclusion amount in effect at the time of the gift. In addition, the proposal would allow any remaining portion of the \$5 million exclusion that has not been used during life as an exclusion from recognition of other unrealized capital gains on property transferred by reason of death. This exclusion would be portable to the decedent's surviving spouse under the same rules that apply to portability for estate and gift tax purposes (resulting in a married couple having an aggregate \$10 million exclusion) and would be indexed for inflation after 2024. The recipient's basis in property, whether received by gift or by reason of the decedent's death, would be the property's fair market value at the time of the gift or the decedent's death.

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

security to continue this deferral. That security could be provided from any person, and in any form, deemed acceptable by the IRS.

Additionally, the proposal would include other legislative changes designed to facilitate and implement the proposal, including without limitation: the allowance of a deduction for the full cost of appraisals of appreciated assets; the imposition of liens; the waiver of penalty for underpayment of estimated tax to the extent that underpayment is attributable to unrealized gains at death; the grant of a right of recovery of the tax on unrealized gains; rules to determine who has the right to select the return filed; the achievement of consistency in valuation for transfer and income tax purposes; coordinating changes to reflect that the recipient would have a basis in the property equal to the value on which the capital gains tax is computed; and a broad grant of regulatory authority to provide implementing rules.

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

The proposal would be effective for gains on property transferred by gift, and on property owned at death by decedents dying, after December 31, 2024, and on certain property owned by trusts, partnerships, and other non-corporate entities on January 1, 2025.

## **IMPOSE A MINIMUM INCOME TAX ON THE WEALTHIEST TAXPAYERS**

### **Current Law**

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

### **Reasons for Change**

Preferential treatment for unrealized gains disproportionately benefits high-wealth taxpayers and provides many high-wealth taxpayers with a lower effective tax rate than many low- and middle-income taxpayers. Preferential treatment for unrealized gains also exacerbates income and wealth disparities, including by gender, geography, race, and ethnicity.

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

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

### **Proposal**

The proposal would impose a minimum tax of 25 percent on total income, generally inclusive of unrealized capital gains, for all taxpayers with wealth (that is, the difference obtained by subtracting liabilities from assets) greater than \$100 million.

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

A taxpayer's minimum tax liability would equal the minimum tax rate (that is, 25 percent) times the sum of taxable income and unrealized gains (including on ordinary assets) of the taxpayer, less the sum of the taxpayer's unrefunded, uncredited prepayments and regular tax. Payments of the minimum tax would be treated as a prepayment available to be credited against subsequent taxes on realized capital gains to avoid taxing the same amount of gain more than once. The amount of a taxpayer's "uncredited prepayments" would equal the cumulative minimum tax

liability assessed (including installment payments not yet due) for prior years, less any amount credited against realized capital gains in prior years.

Uncredited prepayments would be available to be credited against capital gains taxes due upon realization of gains, to the extent that the amount of uncredited prepayments, reduced by the cumulative amount of unpaid installments of the minimum tax (net uncredited prepayments), exceeds 25 percent of unrealized gains. Refunds would be provided to the extent that net uncredited prepayments exceed the long-term capital gains rate (inclusive of applicable surtaxes) times the taxpayer's unrealized gains – such as after unrealized loss or charitable gift. However, refunds would first offset any remaining installment payments of minimum tax before being refundable in cash.

Minimum tax liability would be reduced to the extent that the sum of minimum tax liability and uncredited prepayments exceeds two times the minimum tax rate times the amount by which the taxpayer's wealth exceeds \$100 million. As a result, the minimum tax would be fully phased in for all taxpayers with wealth greater than \$200 million.

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

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

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

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

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

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

## **MODIFY RULES RELATING TO RETIREMENT PLANS**

### **PREVENT EXCESSIVE ACCUMULATIONS BY HIGH-INCOME TAXPAYERS IN TAX-FAVORED RETIREMENT ACCOUNTS AND MAKE OTHER REFORMS**

#### **Current Law**

Individuals may save for retirement through a tax-favored retirement arrangement. The tax-favored retirement arrangement could be an employer-sponsored plan, such as a qualified plan under section 401(a), a section 403(b) plan, a simplified employer pension (SEP), a SIMPLE-IRA plan, or an eligible deferred compensation plan described in section 457(b), or it could be an individual retirement account or annuity (IRA) described in section 408(a) and 408(b).

Employer-sponsored plans and IRAs have distinct characteristics. The following briefly summarizes these rules for employer-sponsored plans and IRAs:

#### **1. Contributions to an employer-sponsored plan**

An employee who saves through an employer-sponsored plan is subject to a limit on elective contributions. For 2024, the annual limit on these elective contributions is generally \$23,000, except that an employee who is at least 50 years old generally can contribute an additional \$7,500. The \$23,000 contribution limit and the \$7,500 “catch-up contribution” limit are adjusted for inflation. An employer can also provide matching contributions or non-elective contributions under its plan (and may also permit the employee to make after-tax contributions), but there is a limit on the total of the employer and employee contributions (other than rollover contributions) for a year. For 2024, that limit is \$69,000 in the case of a qualified plan, a section 403(b) plan, or SEP (with lower limits for a SIMPLE-IRA plan and an eligible deferred compensation plan), except that a taxpayer who is at least 50 years old can make the additional catch-up contribution (generally \$7,500, with a lower amount in the case of certain plans). The \$69,000 contribution limit is adjusted for inflation.

Employer contributions and an employee’s elective contributions to an employer-sponsored plan are generally excluded from an employee’s income for the year of the contribution (but the contributions and earnings on those contributions are included in the distributee’s income when distributed). However, an employer may design the plan to provide its employees the option of designating some or all of an employee’s elective contributions (or a vested employer’s contributions) as Roth contributions. Designated Roth contributions are included in the employee’s income when they are made, but the contributions, and earnings on the contributions, are excluded from income when distributed, if the distribution satisfies the requirements to be a qualified distribution.

#### **2. Contributions to an IRA**

A taxpayer who saves using an IRA is subject to a limit on their contributions (other than rollover contributions). The annual limit on contributions is \$7,000 for 2024, except that a

taxpayer who is at least 50 years old can contribute an additional \$1,000. The \$7,000 contribution limit and the \$1,000 “catch-up contribution” limit are adjusted for inflation.

If a taxpayer’s contribution to an IRA for a year exceeds the allowable contribution for that taxpayer and the taxpayer does not withdraw that excess contribution and net income attributable to the excess prior to the tax filing deadline (with extensions) for the year, then the taxpayer is subject to an annual 6 percent excise tax on the amount of the excess contribution.

The tax treatment of a contribution to an IRA depends on whether the IRA is a traditional IRA or a Roth IRA. A taxpayer may deduct a contribution to a traditional IRA; however, if the taxpayer or the taxpayer’s spouse is an active participant in an employer-sponsored plan, then the deduction is available only if the taxpayer’s income is below a specified limit. A taxpayer for whom the deduction is limited or unavailable because of the income limit for an active participant can make an after-tax contribution to a traditional IRA (and a taxpayer who is not so limited can also choose to make an after-tax contribution rather than deduct that contribution).

Contributions to a Roth IRA are not deductible when they are made, but the contributions, and earnings on the contributions, are excluded from income when distributed, if the distribution satisfies the requirements to be a qualified distribution. A taxpayer may not contribute to a Roth IRA if the taxpayer’s income for the year exceeds certain thresholds.

The following five features of the rules applicable to tax-favored retirement arrangements under current law are addressed by the proposal:

1. Distribution rules, including rules for required minimum distributions

Under current law, taxpayers are not required to receive a distribution from tax-favored retirement arrangements due to the vested account balance exceeding a specified amount. Instead, under current law, taxpayers are required to commence to receive distributions from their tax-favored retirement arrangement when they attain a specified age, except in the case of a Roth IRA or designated Roth account.

A retired employee who participates in an employer-sponsored plan generally is required to begin distributions from that plan (other than from a designated Roth account under the plan) by the required beginning date (April 1 following the calendar year in which the employee attains age 73) and to take the required minimum distributions (RMDs) over the employee’s life expectancy or lifetime (or over the life expectancy or the lifetime of the employee and a designated beneficiary). If the employee is not a 5 percent owner of the employer then the required beginning date is April 1 following the later of the calendar year in which the employee attains age 73 or the calendar year in which the employee retires.

A taxpayer who has an IRA is also subject to the RMD rules. However, there is no RMD requirement for a Roth IRA during the lifetime of the IRA owner (although the beneficiary of the IRA is subject to the RMD rules after the IRA owner dies). If an IRA owner has more than one IRA (or a taxpayer is the beneficiary of more than one IRA from the same decedent) then the total of the RMD requirements for a year calculated for all of those IRAs may be satisfied by a

distribution from any of those IRAs. However, the RMD requirements for IRAs that are not Roth IRAs cannot be satisfied by distributions from a Roth IRA and the RMD requirements for Roth IRAs cannot be satisfied by distributions from an IRA that is not a Roth IRA.

If a taxpayer is subject to the requirement to take an RMD for a year and does not take the full amount required, then the taxpayer is subject to a 25 percent excise tax on the portion of the distribution not taken (reduced to 10 percent if the failure is corrected within a specified period).

A distribution of an eligible rollover distribution from an employer-sponsored tax-favored retirement plan is subject to mandatory income tax withholding at a 20 percent tax rate. A nonperiodic distribution from an IRA (other than from a Roth IRA) is subject to income tax withholding at a 10 percent tax rate. However, an individual can elect to have no withholding apply to a nonperiodic distribution from an IRA.

## 2. Rollovers and conversions to designated Roth retirement accounts or to Roth IRAs

Under current law, an employer may design its plan to permit employees who participate in the plan to elect to rollover a distribution from the plan that is not from the designated Roth account (or to transfer a portion of the balance of the employee's account that is not held as a designated Roth account) into a designated Roth account. Any amount so rolled over or transferred (sometimes referred to as a conversion) is included in the employee's income to the same extent as if the amount rolled over or transferred were distributed (except that the additional income tax for early distributions does not apply).

An employer may also design the plan to provide the employee with the option to make after-tax contributions that are not designated Roth contributions. These after-tax contributions are excluded from income when distributed (but earnings on those contributions are included in income when distributed). If an employee has made after-tax contributions to the plan, then generally a portion of each distribution is treated as coming from the employee's after-tax contributions and the remainder of the distribution is a taxable distribution of employer contributions and earnings (with the proportions of those amounts for the distribution based on the total of those amounts for the employee as a whole).

Individuals are permitted to roll over a distribution from an employer-sponsored tax-favored retirement plan or from an IRA to a Roth IRA. If the distribution was from an account other than a designated Roth account (or was from an IRA other than a Roth IRA) any amount rolled over is included in the employee's income to the same extent as if the amount rolled over was distributed (except that the additional income tax for early distributions does not apply). These rollovers are sometimes called conversions.

## 3. IRA prohibited transactions

If the individual for whom an IRA is established engages in a prohibited transaction, the account loses its tax-favored retirement account status as of the first day of the taxable year in which the transaction occurs and the account is treated as if all the assets in the account were distributed on that day. A prohibited transaction is any direct or indirect: (a) sale or exchange, or leasing, of any

property between the IRA and a “disqualified person”; (b) lending of money or other extension of credit between the IRA and a disqualified person; (c) furnishing of goods, services, or facilities between the IRA and a disqualified person; (d) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of the IRA; (e) act by a disqualified person who is a fiduciary whereby they deal with the income or assets of the IRA in their own interest or for their own account; or (f) receipt of any consideration for their own personal account by any disqualified person who is a fiduciary from any party dealing with the IRA in connection with a transaction involving the income or assets of the IRA.

A disqualified person includes a fiduciary, certain members of a fiduciary’s family, and certain entities controlled by a fiduciary. A fiduciary is any person who: (a) exercises any discretionary authority or discretionary control respecting management of the IRA or exercises any authority or control respecting management or disposition of its assets; (b) renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so; or (c) has any discretionary authority or discretionary responsibility in the administration of such plan.

Section 4975 imposes an excise tax on a disqualified person who participates in a prohibited transaction (other than an IRA owner who engages in that transaction) in an amount equal to 15 percent of the amount involved, up to 100 percent of the amount involved if the prohibited transaction is not corrected.

#### 4. DISC and FSC ownership interests

A domestic international sales corporation (DISC) that earns qualified export receipts may exempt a portion of that income, subject to an interest charge imposed on the shareholders of the DISC with respect to those tax-deferred amounts. Shareholders of the DISC are taxed with respect to qualified export receipts of the DISC either upon actual distribution or deemed distribution from the DISC. The effect of these rules is to defer tax liability except to the extent that the interest charge reduces that deferral benefit.

A foreign sales corporation (FSC) that earns foreign trading gross receipts may exempt a portion of that income. Shareholders of the FSC are generally not subject to tax when those amounts are distributed to them. The FSC provisions were generally repealed by the FSC Repeal and Extraterritorial Income Exclusion Act of 2000, subject to transition rules.

#### 5. Statute of Limitations

The Internal Revenue Code includes a general rule under which the assessment of tax must occur within 3 years of the date that a return is filed. For purposes of the excise tax on excess contributions under section 4973, the return that starts this 3-year period is generally the Form 5329, Additional Taxes on Qualified Plans (including IRAs) and Other Tax-Favored Accounts. As an alternative, a taxpayer can file an income tax return without attaching the Form 5329 (in which case the period for assessment extends to 6 years after the date the return is filed). For purposes of the excise tax on prohibited transactions, the return that starts the 3-year period is the Form 5330, Return of Excise Taxes Related to Employee Benefit Plans.

## **Reasons for Change**

The purpose of tax-favored retirement arrangements is to help people save for retirement. In recent years, it has become clear that some taxpayers have been able to accumulate amounts in tax-favored retirement arrangements that are far in excess of the amount needed for retirement security. In addition, the exemption from required minimum distribution rules for Roth IRAs means that a taxpayer who has other sources of retirement income could choose to continue accumulating investment returns on a tax-favored basis until the taxpayer dies, which means that the tax-favored retirement arrangement could be passed on in its entirety to the taxpayer's heirs. By requiring a high-income taxpayer with an excessive accumulation in tax-favored retirement arrangements to distribute a portion of that excess (and to cease contributions to an IRA), the arrangements would be used for the intended retirement savings purpose. This is especially important if the taxpayer has an excessive accumulation in a Roth IRA or in a designated Roth account in an employer-sponsored tax-favored plan (because of the lifetime exemption from the RMD rules). Prohibiting a high-income taxpayer from converting an amount into a Roth IRA will minimize the extent to which the taxpayer can take advantage of the exemption from the RMD rules for Roth IRAs.

Some taxpayers have avoided the income-based limitations on making Roth IRA contributions by (a) making a non-deductible contribution to a traditional IRA or an after-tax contribution to an employer-sponsored plan, (b) taking a distribution from that IRA or plan, and (c) rolling that distribution into a Roth IRA. This practice inappropriately sidesteps the income restrictions on contributions to Roth IRAs.

Some IRA owners or beneficiaries have taken the position that they are not fiduciaries. As a result, they take the position that they, their family members, and entities that they control are not disqualified persons (so that they may participate in transactions with the IRA that would otherwise be prohibited).

Some taxpayers have directed their Roth IRA to purchase a DISC or FSC ownership interest in order to use the special tax characteristics of those corporations to funnel excessive amounts into the IRA. These transactions, the subsequent payment of commissions to the DISC or FSC, and the distributions from the DISC or FSC to the Roth IRA have, in substance, violated the annual limitation on contributions to a Roth IRA.<sup>21</sup>

It is difficult for the Internal Revenue Service to enforce the IRA rules, particularly in the case of IRAs that are invested in hard-to-value assets. For example, it may be difficult for the IRS to identify if a transaction with the IRA has inappropriately transferred value into the IRA or to identify whether a prohibited transaction has occurred.

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<sup>21</sup> *Summa Holdings, Inc. v. Commissioner*, 848 F.3d 779 (6<sup>th</sup> Cir. 2017), reversing T.C. Memo. 2015-119; *Mazzei v. Commissioner*, 998 F.3d 1041 (9<sup>th</sup> Cir. 2021), reversing T.C. Memo. 2014-55 (in both cases, the application of the substance-over-form judicial doctrine by the United States Tax Court to determine that the arrangements were, in substance, excess contributions, was overturned on appeal).

## **Proposal**

The proposal would make the following changes to current law:

1. Impose special distribution rules on high-income taxpayers with large retirement account balances

The proposal would require a high-income taxpayer with an aggregate vested account balance under tax-favored retirement arrangements that exceeded \$10 million as of the last day of the preceding calendar year to distribute a minimum of 50 percent of that excess. The tax-favored retirement arrangements included in this calculation are: (a) defined contribution plans to which section 401(a) or 403(a) applies; (b) annuity contracts under section 403(b); (c) eligible deferred compensation plans described in section 457(b) maintained by a State, a political subdivision of a State, or an agency or instrumentality of a State or political subdivision of the State; and (d) IRAs. In addition, if the high-income taxpayer's aggregate vested account balance under these tax-favored retirement arrangements exceeds \$20 million, then the required distribution is subject to a floor. The floor is the lesser of (a) that excess and (b) the portion of the taxpayer's aggregate vested account balance that is held in a Roth IRA or designated Roth account.

A taxpayer is considered a high-income taxpayer if for the taxable year the taxpayer's modified adjusted gross income is: (a) over \$450,000, if the taxpayer is married and filing jointly (or is filing as a surviving spouse); (b) over \$425,000, if the taxpayer is a head-of-household; or (c) over \$400,000, in other cases.<sup>22</sup>

The taxpayer would generally be permitted to choose from which of the tax-favored retirement arrangements the required distribution is paid. However, if the floor applies, then the distribution must come first from Roth IRAs and then from designated Roth accounts. In addition, the taxpayer may not specify that any of the required distribution come from an employee stock ownership plan (ESOP) to the extent the account under the ESOP holds employer securities that are not readily tradable on an established securities market (other than any portion of that account attributable to a rollover contribution made after the date of enactment).

The distribution required under the proposal is structured as an increase to the RMD for purposes of the excise tax on failure to take RMDs. As a result, a taxpayer who fails to satisfy the requirement is subject to a 25 percent excise tax on the portion of the distribution not taken (reduced to 10 percent if the failure is corrected within a specified period). The requirement to take this minimum distribution applies without regard to whether an RMD otherwise must be taken by the taxpayer in the year.

The amount distributed would be exempt from the additional income tax on early distributions under section 72(t) and would not be eligible for rollover. If the distribution is from a Roth IRA or from a designated Roth account, then it is treated as a qualified distribution (and therefore is

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<sup>22</sup> The dollar thresholds for the definition of a high-income taxpayer are adjusted for inflation. For this purpose, modified adjusted gross income means adjusted gross income determined without regard to sections 911, 931, and 933, without regard to any deduction for contributions to an individual retirement plan, and without regard to any increase in RMDs under the proposal.

not includible in the taxpayer's income). If the distribution is from a tax-favored retirement arrangement other than an IRA, then it would be subject to mandatory withholding at a 35 percent rate (unless it is from a designated Roth account).

If an individual has an increase in the RMD for a year as a result of the excessive accumulation, any contribution the individual makes to an IRA for the year (other than a rollover) is treated as an excess contribution to an IRA, subject to the 6 percent excise tax under section 4973.<sup>23</sup>

A plan administrator of a tax-favored retirement arrangement that is included in the calculation of whether a high-income taxpayer has an excessive accumulation in tax-favored retirement arrangements would be required to report the vested account balance of any participant or beneficiary for whom the vested account balance exceeds \$2.5 million (as adjusted for inflation) to the Secretary. This requirement would apply without regard to whether the plan administrator is required to file a registration statement for a participant who separated from service under the plan (i.e., it would apply to plans that are not subject to the vesting standards of Title I of ERISA), but it would not apply to an IRA. The report would separately report the portion of the vested account balance that is held in a designated Roth account and the portion of that balance that is held in other accounts.

This provision would be effective for tax years beginning after December 31, 2024, except that the requirement that a plan administrator report vested account balances above \$2.5 million would be effective for plan years beginning after December 31, 2025.

## 2. Limit rollovers and conversions to designated Roth retirement accounts or to Roth IRAs

The provision would prohibit a rollover to a Roth IRA of an amount distributed from an account in an employer-sponsored eligible retirement plan that is not a designated Roth account (or of an amount distributed from an IRA other than a Roth IRA) for a high-income taxpayer. The provision would also prohibit rollovers or transfers of amounts that are not held within a designated Roth account into a designated Roth account for a high-income taxpayer. High-income taxpayers would be defined in the same manner as above. This provision would be effective for taxable years beginning after December 31, 2024.

The proposal also would prohibit a rollover of a distribution from a tax-favored retirement arrangement into a Roth IRA unless the distribution was from a designated Roth account within an employer-sponsored retirement plan or was from another Roth IRA if any part of the distribution includes a distribution of after-tax contributions. Similarly, the proposal would prohibit a rollover of a distribution from a tax-favored retirement arrangement into a designated Roth account if any part of the distribution includes a distribution of after-tax contributions, unless the distribution was from a designated Roth account.

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<sup>23</sup> If a high-income taxpayer does not have such an increase because the individual's aggregate vested account balance in tax-favored retirement arrangements is less than the \$10 million threshold, then any contribution to an IRA (other than a contribution made by an employer under a SIMPLE plan or SEP arrangement) that when added to the aggregate vested account balance in tax-favored retirement arrangements as of the last day of the preceding calendar year would result in a total in excess of \$10 million is also treated as an excess contribution.

This provision would be effective for distributions made after December 31, 2024.

3. Clarify disqualified persons for purposes of IRA prohibited transactions

The proposal would clarify that the individual for whom an IRA is maintained is always a disqualified person for purposes of prohibited transaction rules.

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

4. Prohibit IRA purchase of a DISC or FSC ownership interest

The proposal would prohibit an IRA from holding an interest in a DISC or FSC that receives a payment from an entity owned by the IRA owner. Whether an entity is owned by the IRA owner would be determined by substituting 10 percent for 50 percent in the constructive ownership rules in section 318 of the Internal Revenue Code. The sanction for a violation of this prohibition would be the same as the sanction for an IRA owner engaging in a prohibited transaction (i.e., the IRA would be deemed to have distributed all of its assets as of the first day of the taxable year).

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

5. Extend statute of limitations

The proposal would extend the statute of limitations in the case of a substantial error relating to valuation of assets with respect to an IRA from three years to six years. The proposal would also extend the statute of limitations for the excise tax on prohibited transactions from three years to six years.

This provision would be effective for taxes for which the three-year window would end after December 31, 2024.

## **SUPPORT WORKERS, FAMILIES, AND ECONOMIC SECURITY**

### **EXPAND THE CHILD CREDIT, AND MAKE PERMANENT FULL REFUNDABILITY AND ADVANCEABILITY**

#### **Current Law**

A taxpayer may claim a child tax credit (CTC) for each qualifying child. A qualifying child for the CTC must meet the following five requirements:

1. Relationship – The child generally must be the taxpayer’s son, daughter, grandchild, sibling, niece, nephew, or foster child.
2. Residence – The child must live with the taxpayer in the same principal place of abode for over half the year.
3. Support – The child must not have provided more than half of their own support.
4. Age – The child must be under the age of 17 (or under 18 in taxable year 2021) at the end of the year.
5. Identification – The child must have a taxpayer identification number (TIN) at the time the return is filed. (In taxable years 2021 through 2025 this TIN must be a social security number valid for work.)

The value of the credit, the portion of the credit that may be received as a refund, the presence of a related credit for children and dependents who do not meet the requirements for the CTC, and the income thresholds differ across taxable years. Taxpayers receive the credit in two parts: the portion that offsets tax liability which is generally called the CTC, and the remainder which is potentially received as an additional child tax credit (ACTC).

The American Rescue Plan Act of 2021 (ARP) expanded the CTC for taxable year 2021. Earlier expansions under the Tax Cuts and Jobs Act of 2017 (TCJA) applied in taxable years 2022 and 2023 and still apply for taxable years 2024 and 2025. In later taxable years, most elements of the child credit reflect pre-TCJA law. Specific rules for each period are described below:

#### **CTC for taxable year 2021 (ARP was in effect)**

Taxpayers could claim a CTC for up to \$3,600 for each qualifying child under age 6 and up to \$3,000 for all other qualifying children under age 18. The full amount of the credit was refundable, regardless of the taxpayer’s Federal income tax liability or the presence of earned income.

A taxpayer could also claim a \$500 nonrefundable credit for all qualifying children and other dependents for whom a CTC could not be claimed. This second credit is called the credit for other dependents (ODTC).

The first \$1,600 of the CTC per qualifying child under age 6 and the first \$1,000 per qualifying child age 6 through 17 phased out sequentially with modified adjusted gross income (modified AGI) in excess of \$150,000 for married joint filers or surviving spouses, \$112,500 for head of household filers, and \$75,000 for all other filers, at a rate of \$50 per \$1,000 (or part thereof) of modified AGI in excess of the relevant threshold.

The remainder of the CTC, plus any amount of ODTC, was further reduced by \$50 for each \$1,000 (or part thereof) that exceeded \$200,000 (\$400,000 for married taxpayers filing a joint return) of modified AGI. Larger families followed a modified phaseout rule that extended the AGI range of the phaseout.

Taxpayers could have received up to 50 percent of their estimated total CTC (including ACTC) in advance, in a series of periodic payments. These payments were issued from July to December of 2021 and were based on information reported by taxpayers on their 2020 individual income tax return (or the 2019 return if the 2020 return was not available).

Taxpayers were allowed to opt out of advance payments of the credit. A taxpayer's Federal income tax was increased, dollar for-dollar, if their total CTC advance payments during 2021 exceeded the amount of the CTC to which they were eventually entitled. However, safe harbor rules reduced the additional income tax owed by many low- and moderate-income families, as determined solely by the taxpayer's 2021 modified AGI.

#### CTC for taxable years 2022-2025 (TCJA in effect)

For taxable years 2022 through 2025, a taxpayer may claim a CTC of up to \$2,000 per qualifying child, only part of which is refundable. A taxpayer without sufficient Federal income tax liability to claim the full CTC can claim the ACTC. In 2024 the ACTC will be the lesser of (a) \$1,700 per qualifying child, and (b) 15 percent of earnings in excess of \$2,500, up to the amount of any unclaimed CTC.

A taxpayer may also claim a \$500 ODTC for all children and other dependents for whom a CTC may not be claimed. The sum of the CTC (including any ACTC) and the ODTC is reduced by \$50 for each \$1,000 (or part thereof) that exceeds \$200,000 of modified AGI or \$400,000 of modified AGI for married taxpayers filing a joint return.

The \$1,700 maximum refundable amount per qualifying child in 2024 is indexed for inflation but cannot exceed \$2,000. The maximum credit amount per qualifying child, the income at which the phaseout begins, and the \$2,500 earned income threshold for refundability are not indexed.

#### CTC in taxable years after 2025 (TCJA has expired)

For taxable years beginning after December 31, 2025, a taxpayer may claim a CTC of up to \$1,000 per qualifying child. A taxpayer without sufficient Federal income tax liability to claim the full \$1,000 credit can claim the ACTC. The ACTC will be the lesser of (a) \$1,000 per qualifying child, and (b) 15 percent of earnings in excess of \$3,000, up to the amount of any unclaimed CTC.

The credit will be reduced for single taxpayers with over \$75,000 of modified AGI, \$110,000 for married taxpayers filing a joint return, and \$55,000 for married taxpayers filing separately. No parameters are indexed for inflation.

U.S. territories (permanent changes included in the ARP):

The Code provides for permanent reimbursement of mirror code Territories for the costs of this credit. Puerto Rico's child tax credit is administered by the Internal Revenue Service (IRS) directly. American Samoa has the choice of reimbursement from the IRS for its CTC or administration of the credit by the IRS, and American Samoa has chosen to be reimbursed.

**Reasons for Change**

Expanding the CTC and making it fully refundable will substantially reduce child poverty. The ARP achieved historic reductions in child poverty through the 2021 CTC and advance CTC payment program. Moreover, full refundability would help ensure that families that have been historically excluded from economic opportunities or experienced persistent poverty are fully included in the nation's future growth.

Offering the credit in advance would also make it more useful for families. Periodic payments with a consistent pay date allow families to rely on the income when making their plans to buy groceries, pay bills, or set money aside for a rainy day.

Determining the credit on a monthly basis and basing the rules for determining who can claim a child on who provides care for a child better accommodates the dynamics of modern families and better supports children and their caregivers. Adopting a system of presumptive eligibility will also reduce taxpayer errors and help the IRS administer the law.

Finally, setting up automatic procedures to establish eligibility at birth using information provided via the Social Security Administration's enumeration at birth program will increase take-up and help ensure all eligible families benefit from the credits for which they are eligible.

**Proposal**

For taxable years beginning after December 31, 2023, and ending before January 1, 2026, the proposal would:

1. Increase the maximum credit per child to \$3,600 for qualifying children under age 6 and to \$3,000 for all other qualifying children.
2. Phase out the portion of the credit in excess of \$2,000 with income in excess of \$150,000 of modified AGI for married joint filers or surviving spouses, \$112,500 for head of household filers, and \$75,000 for all other filers, with a modified rule for large families.
3. Increase the maximum age to qualify for the CTC from 16 to 17.

For taxable years beginning after December 31, 2023, the proposal would make the CTC fully refundable, regardless of earned income.

For taxable years beginning after December 31, 2024, the proposal would make additional changes to the CTC to implement an advance payment program so that taxpayers who wish to could receive their credit in a series of advance monthly payments during the year instead of receiving their credit as a lump sum when they file their income tax return in the following year. The Secretary will develop and implement a mechanism for advancing 100 percent of the credit in monthly installments that accommodates changes in family structure and resources over the year. These changes are described in greater detail below.

#### Eligibility and credit amount determined monthly, rather than annually

The proposal would reform the CTC to divide the annual tax credit described above into 12 monthly tax credits, referred to as “monthly specified child allowances.” In general, a taxpayer’s eligibility for, and amount of, a monthly specified child allowance would be determined on a monthly basis, rather than a taxable year basis. The total amount of CTC for a given child would equal the sum of the taxpayer’s allowed monthly specified child allowances for the taxable year.

The monthly specified child allowance would be reduced by 1/12 of 5 percent of the excess of the taxpayer’s modified AGI over the phase-out threshold or thresholds in effect for the taxable year. For taxable years 2024 through 2025, the first phaseout would not reduce a taxpayer’s monthly specified child allowance below \$166.67 per child (that is, \$2,000 per child for the year). For purposes of applying the phase out, the proposal would require the use of the taxpayer’s lowest modified AGI for the three taxable years ending with the taxable year that includes the month for which the monthly specified child allowance would be determined.<sup>24</sup>

#### Replacement of “qualifying child” with “specified child” standard

The proposal would replace the historical “qualifying child” eligibility standard with a new “specified child” standard solely for purposes of the child credit that would focus primarily on the source of care received by the child. A child would qualify as a “specified child” of a taxpayer only if the child (a) shared the taxpayer’s principal place of abode for more than one-half of the month and (b) received uncompensated care from the taxpayer, disregarding compensation received from Federal, State, local, or Tribal governments. A taxpayer would be determined to have provided the required “care” to a child based on all facts and circumstances, including (a) supervision of the child’s daily activities, (b) maintenance of a secure environment

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<sup>24</sup> For example, for purposes of claiming any remaining credit on a tax year 2024 return (filed in 2025), the taxpayer would use the lowest modified AGI from their tax year 2022, 2023, or 2024 Federal income tax return. For purposes of determining the monthly advance child payment amount in January 2025, at which time the taxpayer has not yet filed their 2024 return, the IRS would use the modified AGI from the taxpayer’s tax year 2023 Federal income tax return. Suppose the taxpayer files a 2024 return in February 2025. Then, for purposes of calculating the taxpayer’s monthly advance child payment amount in March 2025, the IRS would use the lowest modified AGI from the taxpayer’s tax year 2023 and 2024 returns. However, if the taxpayer subsequently reported to the IRS their expected modified AGI for 2025 – for example, through the portal described in this text – then the IRS would use the lowest of their expected modified AGI for 2025 and the modified AGI amounts from the taxpayer’s tax year 2023 and 2024 Federal income tax returns to calculate the monthly payment amount for the remaining months of 2025.

for the child, (c) arrangement of medical care for the child, and (d) the involvement in, and other financial support for, the education of the child.

Under the proposal, the taxpayer first allowed to claim a child as a specified child following the child's birth would be allowed to claim the child in all months during the same calendar year prior to the child's birth. In addition, the taxpayer last allowed to claim a child as a specified child prior to the child's death would be allowed to claim the child in all months during the same calendar year after the child's death.

The proposal also would revise the historical tie-breaker rules that have addressed situations when a child is a qualifying child of multiple taxpayers, only one of whom can claim the CTC under current law, as well as other rules.

#### Establishment of presumptive eligibility

The proposal would establish a "presumptive eligibility" concept to determine when a taxpayer would be eligible to claim a monthly specified child allowance or receive a monthly advance child payment.

Once a taxpayer establishes presumptive eligibility with respect to a child, that child would be treated as a specified child of the taxpayer for each month during the period of the taxpayer's presumptive eligibility. Therefore, the taxpayer would be eligible to claim a monthly specified child allowance or receive a monthly advance child payment with regard to that child until the date on which the taxpayer's presumptive eligibility terminates. In addition, the proposal would prohibit that child from being treated as a specified child of any other taxpayer with respect to whom a period of presumptive eligibility has not been established.

Under the proposal, taxpayers would establish presumptive eligibility solely by filing a Federal income tax return, using an online information portal, or pursuant to any other procedures established by the Secretary. Among other requirements, the taxpayer must express a reasonable expectation and intent that the taxpayer will continue to be eligible to claim the child for the credit. The proposal also would authorize the Secretary to provide any additional requirements for taxpayers to establish presumptive eligibility.

A taxpayer's period of presumptive eligibility would begin with the month for which presumptive eligibility is established and end with the earliest of three dates. First, a taxpayer's period of presumptively eligibility would be treated as never existing if the Secretary determines that the taxpayer committed fraud or intentionally disregarded rules or regulations in establishing or maintaining presumptive eligibility. Second, a taxpayer's presumptive eligibility period would terminate in the month specified by the Secretary in a written notice provided to the taxpayer that terminated or suspended presumptive eligibility due to a question regarding eligibility. Finally, a taxpayer's presumptive eligibility period would terminate on the first month following any failure of the taxpayer to make the required annual renewal of presumptive eligibility. In such case, the Secretary would be required to provide to the taxpayer written notification of the termination as well as information on how to reestablish their presumptive eligibility.

### Automatic presumptive eligibility based on information-sharing with trusted partners

The proposal would require the Secretary to issue regulations or other guidance to establish procedures by which a parent of a child born during a month would be treated as automatically establishing presumptive eligibility with respect to that child, including through information provided to the Secretary via the Social Security Administration's enumeration at birth program. The proposal also would require the Secretary to issue regulations or other guidance to establish procedures under which a taxpayer would be treated as automatically establishing presumptive eligibility with respect to a child based on information provided to the Secretary by one or more government entities, including, for example, the Social Security Administration, State Medicaid agencies, or State agencies administering the Supplemental Nutrition Assistance Program.

### Automatic grace period to address certain failures to timely establish presumptive eligibility

The proposal would provide two types of automatic grace periods under which a taxpayer who failed to establish presumptive eligibility in a timely way could receive monthly specified child allowances or retroactive monthly advance child payment for prior months in which the taxpayer otherwise would have been presumptively eligible. First, in the absence of fraud or reckless disregard for any rules or regulations, a taxpayer could automatically receive a three-month grace period in the case of any failure or delay to establish presumptive eligibility with respect to a child. Such taxpayer would not be able to receive this automatic relief more frequently than once every 36-month period. Second, the proposal would authorize the Secretary to provide an extended six-month grace period in cases of domestic violence, serious illness, natural disaster, and any other hardships. No limitation in frequency would be imposed with regard to this second form of relief.

### Monthly advance child payment program

The proposal would require the Secretary to establish a program for making monthly advance child payments. A "monthly advance child payment" of a taxpayer would equal 100 percent of the amount of the taxpayer's monthly specified child allowance estimated by the Secretary for the calendar month based on the taxpayer's relevant "reference month" and "reference taxable year." In determining the estimated amount of a taxpayer's monthly advance child payment, the proposal would authorize the Secretary to consider all available information with regard to the taxpayer.

The proposal also would provide safeguards to ensure that the Secretary has adequate information, as well as time to verify such information, before disbursing any monthly advance child payment. Specifically, no month or year would be treated as a "reference month" or "reference taxable year" upon which a monthly advance child payment could be made unless (a) all relevant information with respect to that month or year is available to the Secretary, and (b) the Secretary has adequate time to make estimates on the basis of such information before the beginning of such calendar month. In the case in which the Secretary has insufficient information to make a monthly advance child payment, the Secretary would not disburse a payment until after the Secretary receives and verifies sufficient information.

### Form and manner of monthly advance child payments

The proposal generally would require that the Secretary disburse monthly advance child payments through electronic funds transfer to the same extent and in the same manner as if those payments were Federal payments not made under the Code. In addition, any monthly advance child payment would not be subject to reduction or offset of (a) past-due support against overpayments, (b) collection of debts owed to Federal agencies, (c) collection of past-due, legally enforceable State income tax obligation, (d) collection of unemployment compensation debts, and (e) any similar authority permitting offset. In addition, the proposal would mandate that such payments could not be reduced or offset by other assessed Federal taxes that would otherwise be subject to levy or collection.

The proposal also would provide rules for the U.S. territories to facilitate the ability of those territories to provide monthly advance child payment programs.

### Establishment of online information portal

To facilitate the sharing of information between taxpayers and the IRS, the proposal would require the Secretary to establish an online information portal similar to the online portal required by the ARP. This online portal would allow a taxpayer to (a) elect to begin or cease receiving monthly advance child payments, and (b) provide information to the Secretary for determining the taxpayer's eligibility for, and amount of, monthly advance child payments. The proposal would authorize the Secretary to expand the information that could be provided through the portal and also establish "specified alternative mechanisms" to help facilitate sharing of information between the IRS and taxpayers for those who lack reasonable access to the internet and in other circumstances where the portal does not suffice.

### Streamlined adjudication process to address competing claims for a specified child

The proposal would provide rules and procedures to address claims by multiple taxpayers of the same specified child. As a general rule, the proposal would require the Secretary to resolve any competing claim among multiple taxpayers in favor of the taxpayer with the most recent reference month. To address instances in which each competing taxpayer relies on the same reference month, the proposal would require the Secretary to establish streamlined procedures under which the Secretary would adjudicate those competing claims of presumptive eligibility. The streamlined adjudication procedures required by the proposal would include an expedited process for taxpayers meeting criteria specified by the Secretary and procedures for adjudicating appeals of an adverse decision. Under the proposal, the Secretary would be authorized to enter into agreements to receive information from, and otherwise coordinate with, Federal agencies; State, local, or Tribal governments; and any other individual or entity the Secretary determines to be appropriate for purposes of adjudicating such claims. The proposal also will authorize the Secretary to make retroactive payments if the Secretary determines that a child is a specified child of a taxpayer and the Secretary did not make payments to that taxpayer during any portion of the period during which the determination was made. Likewise, the Secretary would be authorized to recapture payments from taxpayers based upon a facts-and-circumstances analysis pursuant to procedures established by the Secretary.

### Reconciliation and potential recapture of monthly advance child payments

The proposal would require taxpayers to compare on their Federal income tax return (a) the total amount of the monthly advance child payments received during the taxable year, with (b) the total amount of monthly specified child allowances that the taxpayer could properly claim on that return. If the aggregate amount of allowances exceeds the aggregate amount of payments received during the taxable year, the taxpayer could claim the remaining amount of CTC on their Federal income tax return. If the aggregate amount of allowances is less than the aggregate amount of payments received during the taxable year, the taxpayer may be required to repay the difference, based on the recapture rules described below.

### Statutory repayment protection based on presumptive eligibility

A taxpayer who receives a monthly advance child payment for a child generally would not be required to repay that amount to the IRS if the taxpayer received that payment during a period in which the taxpayer established presumptive eligibility with respect to that child. However, a taxpayer would be required to repay any monthly advance child payment received for a child for whom the taxpayer had not established presumptive eligibility. Similarly, the proposal would require a taxpayer to repay any monthly advance child payments identified for recapture by the Secretary through written notification to the taxpayer.

The proposal also would require taxpayers to repay any excess monthly advance child payments due to understatements or changes of income and changes in filing status by the taxpayer. Specifically, recapture in these circumstances would be required even if the taxpayer had established presumptive eligibility with regard to the child to whom such excess monthly advance child payments were attributable.

In addition, if the taxpayer received monthly payments because of fraud or reckless or intentional disregard of CTC rules and regulations, the proposal would require taxpayers to repay those excess monthly advance child payments. To prevent potential abuse, the proposal also would authorize the Secretary to issue special rules to address taxpayers who have moved to another jurisdiction, as well as any other circumstances that the Secretary determines could give rise to abuse.

The changes described in the above pages to implement an advance monthly payment program would be effective for all taxable years beginning after December 31, 2024. The changes to the maximum credit amounts, phase-out thresholds, age requirements, and refundability would be effective for taxable years beginning after December 31, 2023, and, except for refundability, would expire for taxable years beginning after December 31, 2025.

## RESTORE AND MAKE PERMANENT THE AMERICAN RESCUE PLAN EXPANSION OF THE EARNED INCOME TAX CREDIT FOR WORKERS WITHOUT QUALIFYING CHILDREN

### Current Law

Low- and moderate-income workers may be eligible for a refundable earned income tax credit (EITC). Eligibility for the EITC is based on the presence and number of qualifying children in the worker’s household, the worker’s earned income, adjusted gross income (AGI), investment income, filing status, age, and immigration and work status in the United States.

The EITC has a phase-in range (where each additional dollar of earned income results in a larger credit), a plateau (where additional dollars of earned income or AGI have no effect on the size of the credit), and a phase-out range (where each additional dollar of the larger of earned income or AGI results in a smaller total credit). The phaseout begins at a higher earned income or AGI for joint filers than for other filers. The dollar thresholds and the amount by which the phaseout for joint filers exceeds that for other filers are adjusted annually for inflation. The phase-in rate and the phaseout rate vary with the number of children.

The American Rescue Plan Act of 2021 (ARP) expanded the credit for workers without children in taxable year 2021 by increasing the phase-in and phase-out rates, and increasing the income range over which the credit phases in. These changes increased the maximum credit from \$542 to \$1,502.

Under current law and prior to ARP, the taxpayer must be at least 25 years old and less than 65. In the case of married taxpayers filing jointly, at least one spouse must have been within the age range. The ARP decreased the minimum age at which a taxpayer could claim the credit and eliminated the maximum age at which a taxpayer could claim the credit for 2021.

The following chart shows the 2024 current law parameters for workers without children and what those parameters would have been in 2024 had ARP been extended.

**EITC PARAMETERS FOR WORKERS WITHOUT CHILDREN IN 2024**

<b>EITC Parameter</b>	<b>2024 Current Law</b>	<b>2024 ARP Extended</b>
Credit phase-in rate	7.65%	15.30%
Credit phase-out rate	7.65%	15.30%
End of phase-in range	\$8,260	\$11,430
End of plateau	\$10,330	\$13,510
(married joint filers)	\$17,250	\$20,430
End of phase-out range	\$18,590	\$24,940
(married joint filers)	\$25,510	\$31,860
Maximum credit	\$632	\$1,749
Investment income max	\$11,600	\$11,600

## **Reasons for Change**

The permanent EITC for workers without children is relatively small and phases out at very low incomes. As such, it provides little or no assistance to individuals at or near the poverty line. For example, in 2024 a single worker without children who earned \$15,000 (a wage close to the poverty line), would be in the phase-out range and eligible for a credit of about \$275. This credit would generate a net refund of about \$235 after subtracting their Federal income tax. (The taxpayer would pay over \$1,100 in Federal payroll taxes.) A larger EITC for workers without children would promote employment and reduce poverty for this group of workers. It also would increase the progressivity of the Federal tax system.

The current age restrictions prevent young workers and older workers from claiming the EITC. As a result, young workers living independently from their families are unable to benefit from the anti-poverty and work-related effects of the EITC just when they are establishing the patterns of behavior that may persist throughout their working lives. The EITC, by increasing the effective after-tax wage, encourages additional work.

## **Proposal**

The proposal would restore for taxable year 2024 and make permanent the increase in the EITC parameters for workers without children enacted in the ARP. The end of the phase-in and the end of the plateau would be indexed for inflation in the same manner as other EITC parameters (by the Chained Consumer Price Index for All Urban Consumers, or C-CPI-U). The EITC parameters that would be in place for 2024 are those presented in “2024-ARP Extended Parameters” of the table above.

The proposal would also restore for taxable year 2024 and make permanent the ARP expansion of age-eligibility. As under ARP law, taxpayers who could be claimed as a qualifying child or a dependent would not be eligible for the EITC for childless workers. Thus, full-time students who are dependents of their parents would not be allowed to claim the EITC for workers without qualifying children, despite meeting the new age requirements, even if their parents did not claim them as a dependent or qualifying child for other tax benefits.

More concretely, under the proposal, the taxpayer must be at least 19 years old or at least 24 if a full-time student. In the case of married taxpayers filing jointly, the credit may be claimed if at least one spouse is over age 19 (or at least 24 if a full-time student). Former foster children and qualified homeless individuals are eligible at 18, regardless of student status. The proposal would eliminate the maximum age at which a taxpayer may claim the credit.

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

## **MAKE PERMANENT THE INFLATION REDUCTION ACT EXPANSION OF HEALTH INSURANCE PREMIUM TAX CREDITS**

### **Current Law**

A premium assistance tax credit (premium tax credit or PTC) is provided to certain individuals who purchase health insurance through an exchange in the individual health insurance market established under the Affordable Care Act of 2010 (ACA). The PTC is refundable and payable in advance (as advance payments of the premium tax credit, or APTC) directly to the insurer. Eligibility for the APTC is based on an individual's expected household income and family size. APTC may be updated to reflect mid-year changes in income, marital or other household circumstances, and employment status.

Through 2025, the PTC is generally available to individuals with household income above 100 percent of the Federal poverty line (FPL) for the relevant family size. After 2025, the PTC is generally available to individuals with household income between 100 and 400 percent of the FPL. Individuals are eligible for the PTC only if they are not eligible for health care under programs such as Medicare, Medicaid, the Children's Health Insurance Program, Basic Health Program, TRICARE, or for certain types of health insurance provided through an employer.

A taxpayer's PTC is equal to the lesser of: (a) the premium for the plan chosen by the taxpayer, or (b) the amount by which the cost of the benchmark plan exceeds a required contribution by the taxpayer. The taxpayer's required contribution is a percentage of household income (the applicable contribution percentage) calculated with reference to the taxpayer's FPL.

The American Rescue Plan Act of 2021 (ARP) decreased the applicable contribution percentages and extended PTC eligibility to taxpayers with household income above 400 percent of FPL for taxable years 2021 and 2022. The Inflation Reduction Act of 2022 (IRA) extended these changes through taxable year 2025. Thus, under current law, the more generous PTC would not be available to consumers enrolling in coverage during the open enrollment period that begins on November 1, 2025. Unlike prior law, which had a sharp household income limitation on eligibility for the credit, the PTC under ARP and IRA phases out with income as the required contribution eventually exceeds the benchmark premium. By fixing the parameters for five years, the ARP and IRA paused the pre-ARP indexation of the applicable contribution percentage.

Applicable contribution percentages for the PTC under ARP/IRA and under prior law are shown in the following table.

**APPLICABLE CONTRIBUTION PERCENTAGES FOR PREMIUM TAX CREDIT<sup>1</sup>**

<b>Percent of FPL</b>	<b>ARP/IRA</b>	<b>Pre-ARP<sup>2</sup></b>
Up to 133%	0%	2%
133% up to 150%	0%	3%-4%
150% up to 200%	0%-2%	4%-6.3%
200% up to 250%	2%-4%	6.3%-8.05%
250% up to 300%	4%-6%	8.05%-9.5%
300% up to 400%	6%-8.5%	9.5%
400%+	8.5%	not eligible

<sup>1</sup> Required contributions increase incrementally between income breaks.

<sup>2</sup> Pre-ARP applicable contribution percentages are indexed beginning in 2015.

**Reasons for Change**

Even with the ACA’s changes to the individual market, health coverage can still be expensive for some families and out of reach for others. Making permanent the ARP and IRA’s expansion of the PTC will reduce individuals’ cost of individual market coverage by increasing the amount and availability of premium tax credits for a wide range of income levels.

**Proposal**

The proposal would make permanent the ARP and IRA decrease in the applicable contribution percentages of household income used for determining the PTC. The proposal would also make permanent the ARP and IRA expansion of PTC eligibility to taxpayers with household income above 400 percent of FPL.

In addition, the proposal would permanently repeal the indexation of the applicable contribution percentages.

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

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

### **Current Law**

Two tax benefits are provided to taxpayers who adopt children: (a) a nonrefundable 100 percent tax credit for a limited amount of qualified expenses incurred in the adoption of a child; and (b) an exclusion from gross income of a limited amount of qualified adoption expenses paid or reimbursed by an employer under an adoption assistance program. For taxable year 2024 the separate limits on qualified adoption expenses for the credit and the exclusion are \$16,810. Taxpayers may use both adoption tax benefits, but the same expenses cannot be used for both benefits. Taxpayers may claim the credit for domestic and foreign adoptions, although the rules differ.

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

Taxpayers who adopt children with special needs may claim the full \$16,810 credit even if total adoption expenses are less than that amount, although credits in excess of actual expenses may only be claimed for the year the adoption is finalized.

In 2024, if modified adjusted gross income (AGI) exceeds \$252,150, both the credit amount and the amount excluded from gross income are reduced pro rata over the next \$40,000 of modified AGI. The maximum credit, the maximum exclusion, and the income at which the phaseout range begins are indexed annually for inflation. The credit and exclusion amounts are per adoption; benefits for a given adoption may be claimed over several years.

Taxpayers may carry forward credit amounts they are unable to use because they have insufficient tax liability for up to five years.

### **Reasons for Change**

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

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

### **Proposal**

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

In addition, taxpayers with unused carryforward amounts from eligible expenses from earlier adoptions would be able to claim the full amount of any unused carryforward on their 2025 tax return. However, unused carryforward amounts that expired before 2025 (pursuant to the 5-year limit under current law) would not be eligible to be claimed.

The proposal would also allow families who enter into a guardianship arrangement with a child that meets the requirements below to claim a refundable credit for the expenses related to establishing the guardianship relationship in the year such requirements are satisfied. Unless otherwise specified, eligible expenses and the timing of claims for guardianships would follow existing rules for domestic adoptions.<sup>25</sup> The extra benefit for special needs adoptions would not be extended to include cases of guardianships.

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

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

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

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

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<sup>25</sup> As with adoption, qualified expenses would include court and attorney fees, travel, and other expenses directly related to and for the principal purpose of establishing guardianship of the child. Taxpayers generally claim a credit for domestic adoption expenses in the taxable year after the expense was paid or incurred, except in the year the adoption is finalized (expenses paid or incurred in the year the adoption is finalized can be claimed as a credit in such year).

## **MAKE PERMANENT THE INCOME EXCLUSION FOR FORGIVEN STUDENT DEBT**

### **Current Law**

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

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

### **Reasons for Change**

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

### **Proposal**

The proposal would make permanent the ARP exclusion of certain student loan amounts forgiven by the lender from gross income.

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

## **EXTEND TAX-PREFERRED TREATMENT TO CERTAIN FEDERAL AND TRIBAL SCHOLARSHIP AND EDUCATION LOAN PROGRAMS**

### **Current Law**

#### Treatment of scholarship income

Gross income generally does not include certain scholarship amounts that are used to pay tuition, required fees, and related expenses (e.g., books, certain computing equipment, fees, and supplies). Scholarship amounts for other expenses, including childcare and travel not incidental to the scholarship, are included in ordinary income. If the scholarship represents payment for teaching, research, or other services required as a condition for receiving the scholarship, including a future work obligation, the scholarship is considered ordinary income (i.e., wage income) and is thus taxable for Federal income tax purposes. These scholarships are generally considered wages taxable for Federal payroll tax purposes as well. However, a separate provision that exempts from payroll taxation the student's earnings from their educational institution may limit payroll tax liability for many, but not all, students whose scholarships have teaching, research, or work requirements.

An exception to the work rule described in the first paragraph exists for recipients of National Health Service Corp (NHSC) scholarships, who provide care to underserved populations, and recipients of awards from certain other scholarship programs. The NHSC is a Health Resources and Service Administration (HRSA) program.

#### Treatment of education loans repaid on another's behalf

Loan amounts repaid on another's behalf are considered ordinary income and are taxable unless excepted through a provision of the Code. Excepted amounts are excluded from income for income and payroll tax purposes. Exceptions include debt repaid under the NHSC Loan Repayment Program, certain State programs intended to increase the availability of health care services in underserved areas, certain work-related loan forgiveness programs, and (through 2025) loan payments made by an employer through a cafeteria plan up to \$5,250 per year.

#### Support for underserved communities

*HRSA programs* described in the Public Health Services Act (PHSA) provide scholarships and loan repayment assistance in exchange for a commitment to work with underserved populations upon graduation or to train medical personnel in shortage areas related to underserved populations. Their programs include the following: the NHSC Scholarship Program, the Nurse Corps Scholarship Program, the Native Hawaiian Health Scholarship Program, the Nurse Corps Loan Repayment Program, the Substance Use Disorder Treatment and Recovery Loan Repayment Program, the Faculty Loan Repayment Program, and the new Child and Adolescent

Mental Health Pediatric Subspecialty Loan Repayment Program.<sup>26</sup> Only the NHSC Scholarship Program and the NHSC Loan Repayment Program receive preferred Federal tax treatment.

*The Indian Health Service (IHS) Scholarship Program and the IHS Loan Repayment Program* described in sections 108 and 104 of the Indian Health Care Improvement Act (Public Law 94-437) provide scholarships and loan repayment assistance in exchange for a commitment to work in IHS facilities. These IHS programs do not receive preferred tax treatment.

*Segal AmeriCorps Education Awards (Segal Awards)* described in subsection D of the National and Community Service Act of 1990 provide assistance with education expenses or student loan repayment upon completion of a term of service with AmeriCorps or other participating service-oriented programs (e.g., Teach For America alumni are eligible for Segal Awards). Segal Awards do not receive preferred tax treatment. In certain limited cases, the grants are transferable.

### **Reasons for Change**

The proposal would provide HRSA loan repayment and scholarship programs and the parallel programs at the IHS with the Federal tax treatment enjoyed by participants in the NHSC programs. These programs serve similar purposes and should be treated similarly for tax purposes. In fact, participants from the different programs may work alongside each other.

The IHS Health Professions Scholarship and IHS Loan Repayment Program are similar to the programs receiving exceptions under current Federal tax law and/or the proposal and should be treated similarly for tax purposes. This change would provide the same treatment to Tribal governments that is provided to State governments offering similar programs.

Segal Awards can be used strictly for education purposes – either for current expenses or loan repayment. As such, they are similar to other scholarship and loan repayment programs receiving exceptions under current Federal tax law and should be treated similarly for tax purposes.

### **Proposal**

The proposal would extend tax preferred treatment for scholarship and loan repayment programs to certain Federal programs dedicated to improving access to medical care for underserved populations. It would do so by adding these programs to the exceptions listed in sections 117(c)(2) (scholarships) and 108(f)(4) (loans), which are provided preferential tax treatment even though they involve a (future) work obligation. The programs that would be added are:

1. Loan Repayment Programs administered by the HRSA as described in the PHSA: the Nurse Corps Loan Repayment Program, the Substance Use Disorder Treatment and Recovery Loan Repayment Program, the Faculty Loan Repayment Program, and the new Child and Adolescent Mental Health Pediatric Subspecialty Loan Repayment Program.

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<sup>26</sup> Scholarship and loan forgiveness programs administered by the HRSA that provide care to underserved communities are described here: <https://bhw.hrsa.gov/funding>. The Child and Adolescent Mental Health Pediatric Subspecialty Loan Repayment program is new.

2. Scholarship Programs administered by the HRSA as described in the PHSA: the Nurse Corps Scholarship Program and the Native Hawaiian Health Scholarship Program.
3. The Indian Health Service (IHS) Scholarship Program and the IHS Loan Repayment Program described in sections 108 and 104 of the Indian Health Care Improvement Act.

In addition, Segal AmeriCorps Education Awards used for current education expenses would be treated like scholarships even though the awards represent payment for services. Awards used to repay student loans would be excluded from income. Transferred awards would also be excluded.

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

## **INCREASE THE EMPLOYER-PROVIDED CHILDCARE TAX CREDIT FOR BUSINESSES**

### **Current Law**

Employers who provide childcare facilities or contract with an outside facility for the provision of care may claim a nonrefundable credit equal to the sum of 25 percent of qualified care expenses and 10 percent of referral expenses, up to a maximum total credit of \$150,000 per year. A qualified facility may include an in-home facility that serves as the principal residence of the operator of the facility. Qualified expenses include the acquisition, construction, rehabilitation or expansion of qualifying properties, operating costs, or contracting with a qualified childcare facility to provide services for the taxpayer's employees.<sup>27</sup>

### **Reasons for Change**

Increased tax credits available to businesses would subsidize the cost and encourage the provision of childcare for employees. On-site childcare is valued by parents, and may generate important benefits such as lower absenteeism, higher employee performance, higher employee retention, and higher employee satisfaction. Clarifying that joint ventures are eligible for the credit would further increase available childcare options.

### **Proposal**

The proposal would retain the structure of the credit under current law. The total credit amount would be the sum of the portion related to qualified care expenses and the portion related to referral expenses subject to an overall cap on the two portions combined.

The proposal would increase the portion of the credit related to qualified care expenses to be 50 percent of the first \$1 million of qualified care expenses. For small businesses with gross receipts less than or equal to \$25 million (inflation adjusted) for the 5-year period preceding the taxable year, this portion of the credit would be 60 percent of the first \$1 million of qualified care expenses. The portion of the credit related to referral expenses would be 10 percent of the first \$1.5 million of referral expenses. The credit would be limited to \$600,000 for employers meeting the receipts threshold above and \$500,000 for all other employers.

In addition, under the proposal, a taxpayer may contract with another party or form a joint venture to incur qualified childcare expenditures or qualified childcare resource and referral expenditures. The taxpayer – and not the contractor, joint venture, or other parties to the joint venture – would be treated as the employer for purposes of the requirements of the credit.

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<sup>27</sup> Qualified childcare expenditures do not include the amounts paid or incurred to acquire, construct, rehabilitate, or expand property that constitutes the principal residence of the taxpayer or an employee of the taxpayer.

Under the proposal, a taxpayer would be required to provide the taxpayer identification number for any qualified childcare facility with which they contract to provide childcare services and any provider of childcare resource and referral services (for which they claim the credit).

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

## **IMPROVE THE DESIGN OF THE WORK OPPORTUNITY TAX CREDIT TO PROMOTE LONGER-TERM EMPLOYMENT**

### **Current Law**

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

Individuals must be certified by a designated local agency as a member of a targeted group. Current WOTC targeted groups include the following: (a) recipients of Temporary Assistance for Needy Families; (b) veterans; (c) people recently convicted of, or released from incarceration for, a felony, (d) residents of an empowerment zone or a rural renewal community who are at least 18 but not yet 40 years old; (e) referrals from State-sponsored vocational rehabilitation programs for the mentally and physically disabled; (f) summer youth employees who are 16 or 17 years old residing in an empowerment zone; (g) Supplemental Nutrition Assistance Program benefits recipients at least 18 years old but not yet 40 years old; (h) Supplemental Security Income recipients; and (i) long-term family assistance recipients, and (j) long-term unemployment recipients.

Qualified first-year wages are capped at the first \$3,000 for summer youth employees, \$10,000 for long-term family assistance recipients, \$12,000 for disabled veterans hired within one year of being discharged or released from active duty, \$14,000 for long-term unemployed veterans, \$24,000 for long-term unemployed veterans who are also disabled, and \$6,000 for all other categories of targeted individuals. In addition, the first \$10,000 of qualified second-year wages paid to long-term family assistance recipients is eligible for a 50 percent credit. A disabled veteran is a veteran entitled to compensation for a service-connected disability.

The WOTC does not apply to an individual who begins work after December 31, 2025.

### **Reasons for Change**

The allowance of the 25 percent credit for employees who work between 120 and 400 hours may encourage the hiring of temporary employees, contrary to the goal of WOTC of providing long-term employment opportunities to members of targeted groups.

### **Proposal**

The proposal would increase the minimum number of hours worked by an individual in the first year of service to become eligible for the WOTC from 120 to 400.

The proposal would be effective for individuals hired after December 31, 2024.

## **PROVIDE TAX CREDITS FOR CERTAIN FIRST-TIME HOMEBUYERS AND HOME SELLERS**

### **Current Law**

Federal law supports homeownership in many direct and indirect ways. For example:

1. For those who itemize, mortgage interest on owner-occupied homes can reduce taxable income.
2. For those who itemize, up to \$10,000 of State and local tax, including property tax, can reduce taxable income.
3. The first \$250,000 of capital gains from the sale of the taxpayer's principal residence is excluded from income. (The exclusion is \$500,000 for married couples filing jointly.)
4. There is generally a penalty for early distributions from qualified retirement accounts, but there is no penalty for early distributions if they are used by a first-time homebuyer to make a down payment on a home.
5. As private companies established by the Federal Government, the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac") buy mortgage loans and package them into mortgage-backed securities, which gives front-line mortgage lenders access to vast supplies of capital for originating additional loans.

There is currently no tax credit to support home purchases by first-time homebuyers, though such credits have existed in the past.

In general, real estate transactions must be reported to the Internal Revenue Service (IRS). Sales of principal residences are generally exempt from this reporting requirement if the sales price is \$250,000 or less (\$500,000 or less for joint filers) and the full amount of the gain on such sale is excludable from gross income under section 121 of the Internal Revenue Code (Code).

### **Reasons for Change**

Increased interest rates following the pandemic have made it more difficult to become a homeowner for the first time, partially because current homeowners are more reluctant to sell a home on which they have a low-interest mortgage.

### **Proposal**

The proposal would provide two refundable tax credits: a refundable credit for qualified first-time homebuyers and a refundable credit for qualified home sellers.

## Homebuyer credit

The first-time homebuyer credit would be equal to ten percent of the purchase price of a home, up to a maximum credit of \$10,000. For multiple individuals who purchase a home together, the maximum credit would be allocated proportionally to ownership interest in the purchased home or in a manner determined by the Secretary in published guidance. The credit allocated to a married individual filing a separate return would not exceed \$5,000. The home must be in the United States.

Under the proposal, a first-time homebuyer would be a natural person<sup>28</sup> who:

1. Purchases a home as a principal residence from an unrelated party; and
2. Had no ownership interest in any other principal residence during the tax year in which the purchase was made or during the prior three tax years.

The credit would phase out with income, beginning at a modified adjusted gross income (AGI) of \$100,000 and ending at a modified AGI of \$200,000. In the case of a married individual filing a separate return, the credit would phase out between \$50,000 and \$100,000. For the purpose of this credit, modified AGI would be equal to adjusted gross income, minus distributions from qualified retirement accounts that were penalty free because they were taken to make a down payment, plus any amount excluded from gross income under Section 911, 931, or 933 of the Code. If there are multiple purchasers and the credit allocated to one or more of them is subject to this phase out, then the phased-out amount would not be reallocated to any of the other purchasers.

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

Under the proposal, a taxpayer must meet the following conditions to qualify for the credit. If multiple individuals purchase a home together, then all the taxpayers must meet the following conditions for any of the taxpayers to qualify for the credit:

1. The taxpayer is a first-time homebuyer.
2. The taxpayer attained age 18 on or before the date of purchase, or the taxpayer purchased the home jointly with a spouse who attained age 18 on or before the date of purchase.
3. The taxpayer was a U.S. citizen or legal permanent resident (green card holder) on the date of purchase, or in the case of a joint return, the couple has elected to treat a nonresident spouse as a permanent resident for tax purposes under section 6013(g) of the Code.

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<sup>28</sup> The natural person (and not a disregarded entity whose transactions and assets are attributed to the person for Federal income tax purposes) must be the purchaser of the home under local real estate law.

4. The taxpayer cannot be claimed as a dependent by another taxpayer.

To claim the credit, a taxpayer must (a) begin using the home as a principal residence no later than 120 days following the purchase, (b) own the home and be using the home as a principal residence on the date on which they file that year's Federal income tax return, and (c) to facilitate the IRS's administration and enforcement of the credit, provide to the IRS on a tax return information from the settlement statement used to complete the home purchase and retain a copy of the settlement statement (and be required to produce the settlement statement upon request).

In general, the taxpayer must continue to use the credited home as a principal residence during the three years following the date of purchase. If, during those three years, the taxpayer disposes of the home or ceases to use it as a principal residence (recapture events), then there is a recapture of the entire previously claimed credit (the recapture amount). That is, for the taxable year of disposition or cessation of residence, the taxpayer's tax liability is increased by the full amount of this credit in all prior taxable years, regardless of when during the three years the disposition or cessation occurs. During those three years, transfer of the credited home is subject to information reporting, regardless of any exception that might otherwise have applied.

The taxpayer's tax liability, however, is not increased (that is, there is no recapture) in certain cases where the taxpayer purchases some other home and starts using it as a principal residence. To avoid recapture, the following conditions must be met: (a) the taxpayer purchases some other home within 120 days of the recapture event, (b) the taxpayer begins using that other home as the taxpayer's principal residence on a date that is both no later than 120 days after it is purchased and no later than 180 days after the recapture event, and (c) the taxpayer includes on a timely filed tax return (including extensions) information from the settlement statement for the purchase of the other home. (The settlement statement must be retained with the taxpayer's books and records for the year of the recapture event.) If there is no recapture because some other home is purchased and all of the above conditions are satisfied, then that other home is subsequently treated like the credited home for purposes of information reporting and for determining whether a recapture event has occurred and whether tax liability must be increased by the recapture amount. A recapture event with respect to the other home does not result in recapture if it occurs three years or more after the purchase of the credited home.

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

#### Home seller credit

The home seller credit would be equal to ten percent of the sales price of a home, up to a maximum credit of \$10,000. For multiple individuals who sell a home together, the maximum credit would be allocated proportionally to ownership interest in the sold home or in a manner determined by the Secretary in published guidance. The credit allocated to a married individual filing a separate return would not exceed \$5,000. The home must be in the United States.

A home seller is a natural person who:

1. Sells a home to an unrelated party; and
2. Had an ownership interest in the home during the tax year in which the sale was made and during the prior tax year.

The credit would phase out with income, beginning at a modified AGI of \$100,000 and ending at a modified AGI of \$200,000. In the case of a married individual filing a separate return, the credit would phase out between \$50,000 and \$100,000. For the purpose of this credit, modified AGI would be equal to adjusted gross income, minus capital gains that were realized as a result of the sale of the home to the extent they are included in AGI, plus any amount excluded from gross income under Section 911, 931, or 933. If there are multiple sellers and the credit allocated to one or more of them is subject to this phase out, then the phased-out amount would not be reallocated to any of the other sellers.

The credit would also phase out with the sales price of the sold home, beginning at a sales price of 80 percent of the area median price and ending at a sales price of 100 percent of the area median price. The area median price would be defined as the median home value within the county of the sold home as reported by the Census Bureau in the 1-year estimates from the American Community Survey. The area median price would be determined annually based on data available as of October 1 of the previous calendar year.

The seller credit would apply to the return for the taxable year in which the home was sold.

Under the proposal, a taxpayer must meet all of the following conditions to qualify for the credit. If multiple individuals sell a home together, then all of the taxpayers must meet the following conditions for any of the taxpayers to qualify for the credit:

1. The taxpayer is a home seller.
2. The taxpayer attained age 18 on or before the date of sale, or the taxpayer sold the home jointly with a spouse who attained age 18 on or before the date of sale.
3. The taxpayer was a U.S. citizen or legal permanent resident (green card holder) on the date of sale, or in the case of a joint return, the couple has elected to treat a nonresident spouse as a permanent resident for tax purposes under section 6013(g).
4. The taxpayer cannot be claimed as a dependent by another taxpayer.

In addition, for a sale to qualify for the credit, the buyer(s) must be a natural person or person(s) and must attest that they intend to own the home and use it as a primary residence for at least one year.

To claim the credit, a taxpayer must (a) provide to the IRS on a tax return information from the settlement statement used to complete the home sale for the purpose of facilitating administration and enforcement and retain a copy of the settlement statement, (b) attest that they did not invoke

the exception to information reporting for certain home sales, and (c) attest that they obtained an attestation from the buyer that they intend to own the home and use it as a primary residence for at least one year and retain a copy of the attestation. The exemption for information reporting on certain home sales would not apply to sales for which the seller intends to claim the credit.

The tax credit would be available for homes sold after December 31, 2023, and before January 1, 2025.

## **MODIFY ESTATE AND GIFT TAXATION**

### **IMPROVE TAX ADMINISTRATION FOR TRUSTS AND DECEDENTS' ESTATES**

#### **Current Law**

##### **Definition of executor**

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

##### **Limit on the reduction in value of special use property**

Generally, the fair market value of real property for estate tax purposes is based on the property’s value at its “highest and best use.” For example, an undeveloped parcel of land might be valued as property that could be developed for residential or commercial purposes. However, the estates of owners of certain real property used in a family-owned trade or business may reduce the value of that property for Federal estate tax purposes below its highest and best use value to help preserve its current use. The maximum reduction in value is limited to \$750,000, as adjusted for inflation since 1997; in 2024, the reduction in value is capped at \$1.39 million.

##### **Duration of certain estate and gift tax liens**

Current law provides an automatic lien on all gifts made by a donor and generally on all property in a decedent’s estate to enforce the collection of gift and estate tax liabilities from the donor or the decedent’s estate, as applicable. The lien remains in effect for 10 years from the date of the gift for gift tax, or the date of the decedent’s death for estate tax, unless the tax is paid in full sooner.

##### **Reporting of estimated total value of trust assets and other information about the trust**

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

## Use of defined value formula clauses to determine bequests or gifts

Taxpayers often want to make gifts, bequests, or disclaimers in an amount that achieves a particular tax result. For example, a taxpayer may wish to avoid triggering gift tax liability by limiting the gift to that amount of property equal to the donor's remaining gift tax exclusion amount.<sup>29</sup> The mechanism used for such transfers is sometimes referred to a "defined value formula clause." That clause purports to define the gift by a value determined by a formula. Often, the formula determines the value by reference to the results of IRS enforcement activities.<sup>30</sup>

## Exclusion from the gift tax for annual gifts

The first \$18,000 of gifts made to each donee in 2024 are excluded from the donor's taxable gifts (and therefore do not use up any of the donor's lifetime exclusion from gift and estate taxes). This annual gift tax exclusion is indexed for inflation and there is no limit on the number of donees to whom such gifts may be made by a donor in any one year. To qualify for this exclusion, each gift must be of a present interest rather than a future interest in the donated property. A present interest is an unrestricted right to the immediate use, possession, or enjoyment of property or the income from property (including life estates and term interests). Generally, a contribution to a trust for the donee is a future interest.

## **Reasons for Change**

### Definition of executor

Because the statutory definition of executor applies only for estate tax purposes, a statutory executor (including a surviving spouse who filed a joint income tax return) has no authority to represent the decedent or the estate with regard to the decedent's final income tax liabilities, failures to report foreign assets, or other tax liabilities and obligations that arose before the decedent's death. Similarly, no one has the authority to extend a limitations statute, claim a refund, agree to a compromise or assessment, or pursue judicial relief with regard to a tax liability of the decedent. Because reporting obligations (particularly regarding interests in foreign assets or accounts) have increased, problems associated with this absence of any representative authority are arising more frequently. Additionally, in the absence of an appointed executor, multiple persons may meet the definition of executor and, on occasion, multiple persons have filed separate estate tax returns for the decedent's estate or have made conflicting tax elections.

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<sup>29</sup> Another common example is defining the bequest that will qualify for the marital deduction as the minimum amount needed to reduce the decedent's estate tax liability to zero.

<sup>30</sup> An example of such a formula is the following: "I give my interest in [entity] as follows: to my children, that number of units having a fair market value as of [date of gift], as finally determined for Federal transfer tax purposes, of [specified amount] dollars; and to [another person, such as a charity], my remaining number of units after satisfying the gifts to my children." Generally, the units remaining after the defined gift are retained by the owner or are given to another person or entity (often a charity or marital trust) whose receipt would not give rise to a gift tax liability.

### Limit on the reduction in value of special use property

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

### Duration of certain estate and gift tax liens

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

### Reporting of estimated total value of trust assets and other information about the trust

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

### Use of defined value formula clauses to determine bequests or gifts

The increasing popularity and use of defined value formula clauses poses a significant challenge to the administration of the gift and income taxes by potentially (a) allowing a donor to escape the gift tax consequences of undervaluing transferred property, (b) making examination of the gift tax return and litigation by the IRS cost-ineffective, and (c) requiring the reallocation of transferred property among donees long after the date of the gift. Further, defined value formula clauses that depend on the value of an asset as finally determined for Federal transfer tax purposes create a situation where the respective property rights of the various donees are being determined in a tax valuation process in which those donees have no ability to participate or intervene.

### Exclusion from the gift tax for annual gifts

Because the annual per-donee gift tax exclusion is available only for gifts of a present interest, taxpayers making a gift in trust usually give the trust beneficiary a limited right to withdraw the trust contribution (a “*Crummey* power”).<sup>31</sup> Generally, a *Crummey* power makes the gift in trust a present interest gift if timely notice of the existence of the power is given to the donee. However, the cost to taxpayers of complying with the notice and record maintenance requirements associated with *Crummey* powers is significant, as is the cost to the IRS of administering these rules. Further, because *Crummey* powers can be granted to an unlimited number of beneficiaries, these powers can be given to multiple discretionary beneficiaries, most of whom are never

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<sup>31</sup> *Crummey* powers are widely used, particularly in life insurance trusts and in irrevocable trusts to hold property for the benefit of minor children.

intended to receive a distribution from the trust, for the primary (if not exclusive) purpose of shielding a larger trust contribution from gift tax.

## **Proposal**

### Expand definition of executor

The proposal would move the existing definition of executor from section 2203 to section 7701 of the Code, expressly making it applicable for all tax purposes, and would authorize such an executor to do anything on behalf of the decedent in connection with the decedent's pre-death tax liabilities or other tax obligations that the decedent could have done if still living. Because this definition frequently results in multiple parties being an executor, the proposal also would grant regulatory authority to the Secretary to adopt rules to resolve conflicts among multiple executors authorized by that provision.

The proposal would apply upon enactment, regardless of a decedent's date of death.

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

The proposal would increase the cap on the maximum valuation decrease for "qualified real property" elected to be treated as special use property to \$14 million. Such property generally would include the real estate used in family farms, ranches, timberland, and similar enterprises.

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

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

The proposal would extend the duration of the automatic lien beyond the current 10-year period to continue during any deferral or installment period for unpaid estate and gift taxes.

The proposal would apply to 10-year liens already in effect on the date of enactment, as well as to the automatic lien on gifts made and the estates of decedents dying on or after the date of enactment.

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

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

the last day of the taxable year exceeds \$300,000 (indexed for inflation after 2025) or whose gross income for the taxable year exceeds \$10,000 (indexed for inflation after 2025).

In addition, each trust (regardless of value or income) would be required to report on its annual income tax return the inclusion ratio of the trust at the time of any trust distribution to a non-skip person, as well as information regarding any trust modification or transaction with another trust that occurred during that year. This additional information will provide the IRS and taxpayers with current information necessary to verify the GST effect of any trust contribution or distribution without requiring either party to go back through multiple prior years' records to determine that information.

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

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

The proposal would provide that, if a gift or bequest uses a defined value formula clause that determines value based on the result of involvement of the IRS, then the value of such gift or bequest will be deemed to be the value as reported on the corresponding gift or estate tax return. However, a defined value formula clause would be effective if (a) the unknown value is determinable by something identifiable other than activity of the IRS, such as an appraisal that occurs within a reasonably short period of time after the date of the transfer (even if after the due date of the return) or (b) the defined value formula clause is used for the purpose of defining a marital or exemption equivalent bequest at death based on the decedent's remaining transfer tax exclusion amount.

The proposal would apply to transfers by gift or on death occurring after December 31, 2024.

#### Simplify the exclusion from the gift tax for annual gifts

The proposal would eliminate the present interest requirement for gifts that qualify for the gift tax annual exclusion. Instead, the proposal would define a new category of transfers (without regard to the existence of any withdrawal or put rights) and would impose an annual limit of \$50,000 per donor, indexed for inflation after 2025, on the donor's transfers of property within this new category that would qualify for the gift tax annual exclusion. This new \$50,000 limit would not provide an exclusion in addition to the annual per-donee exclusion; rather, it would be a further limit on those amounts that otherwise would qualify for the annual per-donee exclusion. Thus, a donor's transfers in the new category in a single year in excess of a total amount of \$50,000 would be taxable, even if the total gifts to each individual donee did not exceed \$18,000. The new category would include transfers in trust (other than to a trust described in section 2642(c)(2)), transfers of interests in pass-through entities, transfers of interests subject to a prohibition on sale, partial interests in property, and other transfers of property that, without regard to withdrawal, put, or other such rights in the donee, cannot immediately be liquidated by the donee.

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

## LIMIT DURATION OF GENERATION-SKIPPING TRANSFER TAX EXEMPTION

### Current Law

The generation-skipping transfer (GST) tax is imposed on gifts and bequests by an individual transferor to transferees who are two or more generations younger than the transferor. Each individual has a lifetime GST tax exemption (\$13.61 million in 2024) that can be allocated to transfers made by that individual to a grandchild or other “skip person,” whether directly or in trust. Allocating GST exemption does not directly exempt any assets or portion of a trust from tax. Rather, allocating GST exemption to a trust or transfer reduces the applicable rate of tax (from as high as 40 percent to as low as 0 percent) on generation-skipping transfers.<sup>32</sup> An allocation of GST exemption to a trust excludes from GST tax not only the value to which GST exemption was allocated, but also all subsequent appreciation and accrued income on that value during the existence of the trust.

### Reasons for Change

In most cases, as long as property remains in a trust, the death of a trust beneficiary will not trigger the imposition of estate tax on trust assets. This is because beneficiaries typically have no rights to the trust property that would cause the property to be includable in that beneficiary’s gross estate at death. At the termination of the trust, however, the trust assets are required to vest in one or more persons, at which point the assets become the property of those persons and reenter the gift and estate tax base.

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

### Proposal

The proposal would make the GST exemption applicable only to: (a) direct skips and taxable distributions to beneficiaries no more than two generations below the transferor, and to younger generation beneficiaries who were alive at the creation of the trust; and (b) taxable terminations

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<sup>32</sup> The GST tax is imposed as a flat tax rate equal to the highest estate tax rate (currently 40 percent) multiplied by the trust’s “inclusion ratio.” Generally, the inclusion ratio is determined by subtracting the “applicable fraction” from one. The numerator of the applicable fraction is the total amount of GST exemption allocated to the trust or transfer, and the denominator is the fair market value of the trust or property transferred. For example, if the amount of GST exemption allocated to the trust is equal to the value of property transferred to the trust, the inclusion ratio will be zero and the applicable tax rate will be 0 percent (40 percent multiplied by the inclusion ratio). Such a trust is described as being fully exempt from the GST tax.

occurring while any person described in (a) is a beneficiary of the trust.<sup>33</sup> Under current law, section 2653 resets the generation assignment of trust beneficiaries once GST tax has been imposed, treating younger generations of skip persons as being in the first generation below that of the transferor (and thus as non-skip persons). Under the proposal, section 2653 would not apply in determining the generation assignment of a beneficiary for purposes of testing whether the GST exemption has terminated. In addition, solely for purposes of determining the duration of the exemption, a pre-enactment trust would be deemed to have been created on the date of enactment and, in this case, the proposal would provide that the grantor is deemed to be the transferor and in the generation immediately above the oldest generation of trust beneficiaries in existence on the date of enactment. The result of these proposals is that the benefit of the GST exemption, which shields property from the GST tax, would not last for a trust's duration. Instead, the GST exemption would only shield from GST tax distributions to trust beneficiaries who either are in a generation no younger than that of the transferor's grandchild or are members of a younger generation who were alive at the creation of the trust. Similarly, the exemption would shield a taxable termination from GST tax only as long as a person described in the prior sentence is a trust beneficiary.

Specifically, upon the expiration of this limit on the duration of the GST exemption, the trust's inclusion ratio would be increased to one, thereby rendering no part of the trust exempt from GST tax. Because contributions to a trust from different grantors are deemed to be held in separate trusts under section 2654(b) of the Code, each such separate trust would be subject to the same rule for the duration of the exemption, measured from the date of the first contribution by the grantor of that separate trust. The special rule for pour-over trusts under section 2653(b)(2) would continue to apply to pour-over trusts and to trusts created under a decanting authority, and for purposes of this rule, such trusts would be deemed to have the same date of creation as the initial trust.<sup>34</sup> The other rules of section 2653 would continue to apply and would be relevant in determining when a taxable distribution or taxable termination occurs. An express grant of regulatory authority to the Secretary and her delegates would be included to facilitate the implementation and administration of this provision.

The proposal would apply on and after the date of enactment to all trusts subject to the generation-skipping transfer tax, regardless of the trust's inclusion ratio on the date of enactment.

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<sup>33</sup> The three types of GST transfers are direct skips, taxable distributions, and taxable terminations. Section 2612 defines a direct skip as a transfer to a skip person that is subject to Federal estate or gift tax; a skip person generally is one assigned to a generation more than one generation below that of the transferor. Section 2612 also defines a taxable distribution and taxable termination.

<sup>34</sup> A pour-over trust is a trust to receive assets passing under the will of the grantor at death. In general, decanting involves distributing assets from one trust to a new trust created by the trustee of the first trust, thereby changing the terms of the trust.

## **MODIFY INCOME, ESTATE, GIFT, AND GENERATION-SKIPPING TRANSFER TAX RULES FOR CERTAIN TRUSTS**

### **Current Law**

#### Tax rules for grantor trusts

Generally, a trust is a grantor trust, and the grantor is its deemed owner, if the grantor (a) creates a revocable trust, or (b) creates an irrevocable trust but retains certain powers over the trust or its assets (such as the power to control or direct the trust's income or assets).<sup>35</sup> A deemed owner of a grantor trust is treated as owning the assets of the trust solely for income tax purposes. As a result, sales and other transactions between a grantor trust and its deemed owner are disregarded for income tax purposes so no income tax on gains is incurred. Further, the income tax liability generated by a trust's assets is the obligation of the deemed owner, rather than the obligation of the trust or its beneficiaries. No amount paid by the deemed owner of a grantor trust to satisfy the trust's income tax liability is treated as a gift by the deemed owner to the trust or its beneficiaries for Federal gift tax purposes.

A grantor retained annuity trust (GRAT) is an irrevocable grantor trust in which the grantor retains an annuity interest for a term of years. At the end of that term, the assets then remaining in the trust are transferred to (or held in further trust for) the beneficiaries. The gift of this remainder interest is subject to gift tax at the creation of the trust and is valued by deducting the present value of the grantor's retained annuity interest from the fair market value of the property contributed to the GRAT. The present value of the grantor's retained annuity interest is the value of the expected payments to the grantor during the GRAT term, determined using a discount rate or rate of return based in part on the applicable Federal (statutory) interest rate in effect for the month in which the GRAT is funded.

#### Generation-Skipping Transfer (GST) inclusion ratio on transactions with other trusts

The GST tax is imposed by multiplying the value of a trust by the product of a flat tax rate (equal to the highest estate tax rate, currently 40 percent), and the trust's "inclusion ratio." A trust's inclusion ratio is determined by subtracting the "applicable fraction" from one. Generally, the numerator of the applicable fraction is equal to the amount of GST exemption allocated to the trust and the denominator is equal to the value of the trust. The applicable fraction is redetermined on each allocation of GST exemption to the trust and on certain changes to the trust principal, such as additional contributions to the trust or the consolidation of multiple trusts.

#### GST tax characterization of certain tax-exempt organizations

A taxable termination is one of three types of transfers that triggers the imposition of GST tax. In defining a taxable termination of a trust, the statute provides that there is no taxable termination

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<sup>35</sup> A grantor also can create a trust that gives a beneficiary certain powers over the trust (such as the right to withdraw all of the trust's income). Those powers could make the beneficiary the trust's deemed owner.

as long as a non-skip person has an interest in the trust.<sup>36</sup> Although for this purpose, the current GST statute ignores trust interests held by most charities, there are other types of non-charitable tax-exempt organizations that are treated as non-skip persons. As a result of this characterization, a discretionary interest held by such an organization will prevent a taxable termination and thereby avoid the imposition of GST tax.

#### Definition of a guaranteed annuity from a charitable lead annuity trust (CLAT)

A CLAT requires the payment of an annuity at least annually to one or more charitable beneficiaries for a term of years or for the life of the donor. At the end of that term, the trust distributes any remaining trust property to noncharitable remainder beneficiaries. The CLAT's grantor makes a gift of the remainder interest to the remainder beneficiaries on the creation of the CLAT, and the present value of that deferred remainder interest is based, in part, on an assumed rate of growth for the trust's assets during the annuity term. However, the actual rate of appreciation of the trust's assets can exceed the assumed rate of growth on which the gift tax calculation is based. As a result, the value of the remainder interest subjected to gift tax on the CLAT's creation can be significantly less than the value of the remainder interest received by the noncharitable beneficiaries at the end of the CLAT term.

#### Tax treatment of loans from a trust

The Internal Revenue Code (Code) has complex and comprehensive rules governing the income, GST, and sometimes gift tax consequences of distributions from trusts to trust beneficiaries. Generally, these rules are intended, at least in part, to ensure that those who enjoy the benefits from a trust share an appropriate level of tax liability related to the receipt of those benefits. However, except for certain loans from a foreign trust to a U.S. person, a loan from a trust does not carry with it any tax consequences to the borrower.

### **Reasons for Change**

#### Modify tax rules for grantor trusts

GRATs and grantor trusts allow taxpayers to substantially reduce their combined Federal income, gift, and estate tax obligations through tax planning. The proposal addresses the three most common and significant planning techniques that allow the grantor of a trust to remove significant value from the grantor's gross estate for Federal estate tax purposes without Federal income or gift tax consequences. Reform is needed to close the existing loopholes and ensure the effective operation of the Federal income, gift, and estate taxes. To be effective, any change in the law should address all of these techniques; otherwise, taxpayers will simply shift their planning from one technique to the other.

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<sup>36</sup> A non-skip person is a person other than a skip person. A skip person is either (a) a natural person assigned to a generation which is 2 or more generations below the generation assignment of a transferor to the trust or (b) certain trusts. A trust is a skip person if, at the time of a contribution to the trust, (a) all interests in the trust are held by skip persons, or if (b) there is no person holding an interest in the trust, and at no time after such a contribution may a distribution (including distributions on termination) be made from such trust to a non-skip person.

The first technique is the funding of a GRAT with assets that are expected to appreciate. If the value of a GRAT's assets appreciate at a rate that exceeds the relatively low statutory interest rate used to value the grantor's retained annuity interest, that excess appreciation will have been transferred to the remainder beneficiaries with little or no gift tax. Because almost the entire value of the GRAT assets generally is includible in the grantor's gross estate for Federal estate tax purposes if the grantor dies during the GRAT term, the grantor usually selects a GRAT term that the grantor expects to survive. To minimize the gift tax cost, the GRAT is structured to have a remainder interest with only a very small value and thus incurring very little gift tax. As a result, even if the GRAT assets do not significantly appreciate by the end of the GRAT term, the GRAT involved little to no cost or downside risk for the grantor.

The second technique is the sale of an appreciating asset to a grantor trust by its deemed owner. Generally, when a taxpayer sells an appreciating asset to a grantor trust of which the taxpayer is the deemed owner for income tax purposes,<sup>37</sup> the sale is disregarded for income tax purposes. Such a sale allows the taxpayer to remove the future appreciation from the taxpayer's gross estate without the payment of gift or estate tax and without the recognition of any capital gain on the sale.

The third technique is the deemed owner's repurchase of an appreciated asset from the grantor trust for the asset's then-fair market value, usually shortly before the deemed owner's death. Generally, as with the grantor's sale of an appreciating asset to the trust, when a grantor trust sells an appreciated asset back to the trust's deemed owner, the purchase is disregarded for income tax purposes, so no capital gains tax is incurred. When the deemed owner dies, the appreciated asset is part of the grantor's gross estate, so its basis is adjusted (usually increased) to its fair market value on the date of death. In this way, no gain is ever taxed, and the trust has the same value as immediately before the repurchase by the deemed owner but without the future capital gains tax liability on the appreciation that accrued before the deemed owner's death.

Finally, because the deemed owner's payment of the income tax on the trust's taxable income and gains each year is considered the owner's payment of the owner's own tax liability and therefore is not a taxable gift, the property in the grantor trust can grow free of income tax, without any gift tax cost.

#### Adjustment of a trust's GST inclusion ratio on transactions with other trusts

A popular technique for leveraging the benefit of the GST exemption is for a GST exempt trust<sup>38</sup> to purchase either assets from a GRAT or other trust, or a remainder interest in the GRAT or other trust. Presumably, a taxpayer engaging in such a sale would treat the transaction as any other reinvestment of trust assets, which would not change the purchasing trust's applicable fraction or inclusion ratio. Because the grantor of the GRAT cannot allocate GST exemption to the GRAT until the end of the GRAT term, the GRAT is not exempt from GST tax at the time of

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<sup>37</sup> In most cases, the taxpayer receives the sales price for the appreciating asset in the form of a note issued by the trust to be paid from the future income or return from the asset sold to the trust.

<sup>38</sup> A trust can be exempt from GST tax either because it is a trust treated as having an inclusion ratio of zero under the grandfather rules or it is a trust with an inclusion ratio of zero due to the allocation of the donor's GST exemption.

such a purchase, but the purchase by the GST exempt trust, in effect, cleanses the purchased interest of its GST potential.<sup>39</sup> Therefore, a purchase of the remainder interest shortly after the creation of the GRAT could significantly leverage the taxpayer's GST exemption by avoiding the need to allocate GST exemption at the end of the GRAT term to shield the purchased property from GST tax. While it appears that the categories of the changes to trust principal that trigger a redetermination of a trust's inclusion ratio could be expanded by regulations, it is not clear that regulations could adequately address the effect of sales between trusts.

#### Change the GST tax characterization of certain tax-exempt organizations

Because many types of tax-exempt organizations are included in the definition of a non-skip person with an interest in the trust for purposes of determining taxable terminations, simply naming one of these organizations (other than most charities) as a potential recipient of trust distributions is enough to avoid the imposition of GST tax on the trust, even though that organization may be unlikely to ever receive a distribution from the trust. In this way, the statute has created a loophole being used by taxpayers to avoid GST tax.

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

The term of a CLAT and the size of the annual annuity generally are structured to cause the deferred value of the remainder interest for transfer tax purposes to be minimal or zero even though the actual value of that remainder interest is expected to be substantial. The longer that annuity payments to the charity can be delayed, the longer the trust assets can remain in the trust where the expectation is that they will continue to appreciate in value. Although annuity payments must be made at least annually, the amount of each payment may vary within certain limits. A higher annuity amount payable from the beginning of the trust term can reduce the appreciation that otherwise would accrue for the ultimate benefit of the remaindermen. As a result, taxpayers often design the CLAT to have an annuity that increases over the trust term, thereby largely deferring the charitable benefit until the end of the trust term. This technique can increase very significantly the value of the remainder without gift tax consequences.

#### Modify the tax treatment of loans from a trust

Loans to trust beneficiaries are being used to avoid the income and GST tax consequences of trust distributions. The current widespread practice of making loans rather than distributions from dynastic trusts subject to the GST tax supports the conclusion that loans are an alternative method of obtaining beneficial enjoyment from a trust. Although a loan differs from a distribution because of the obligation to repay, the borrower nevertheless is receiving property from the trust – a benefit that the borrower is unlikely to have been able to otherwise obtain. In addition, these loans often are forgiven or otherwise remain unpaid, and it is difficult for the Internal Revenue Service (IRS) to identify those occurrences and thus to collect the taxes that should be paid in such circumstances. Thus, the use of loans allows taxpayers to divorce their

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<sup>39</sup> In addition, if the GRAT's assets appreciate during the GRAT term at a higher rate than the rate assumed at its creation, the value of the remainder interest at the creation of the GRAT (the value subject to gift tax) is substantially lower than the value of the remainder at the end of the GRAT term.

ability to benefit from trust assets from the receipt of income for tax purposes, which allows them to inappropriately avoid income and GST taxes.

Treating loans as distributions also would facilitate tax administration and compliance by providing the IRS with greater visibility into transactions with trusts and information about who is benefiting from a trust.

## **Proposal**

### **Modify tax rules for grantor trusts**

The proposal would require that the remainder interest in a GRAT, at the time the interest is created, have a minimum value for gift tax purposes equal to the greater of 25 percent of the value of the assets transferred to the GRAT or \$500,000 (but not more than the value of the assets transferred). In addition, the proposal would prohibit any decrease in the annuity during the GRAT term and would prohibit the grantor from acquiring in an exchange an asset held in the trust without recognizing gain or loss for income tax purposes. Finally, the proposal would require that a GRAT have a minimum term of ten years and a maximum term of the life expectancy of the annuitant plus ten years. These provisions would impose some downside risk on the use of GRATs so they are less likely to be used purely for tax avoidance purposes.

For trusts that are not fully revocable by the deemed owner, the proposal would treat the transfer of an asset for consideration between a grantor trust and its deemed owner or any other person as one that is regarded for income tax purposes, which would result in the seller recognizing gain on any appreciation in the transferred asset and the basis of the transferred asset in the hands of the buyer being the amount the buyer paid to the seller. Such regarded transfers would include sales as well as the satisfaction of an obligation (such as an annuity or unitrust payment) with appreciated property. However, securitization transactions would not be subject to this new provision. (A corresponding addition to disallowed losses would be made to section 267(b) of the Code).

The proposal also would provide that the payment of the income tax on the income of a grantor trust (other than a trust that is fully revocable by the grantor) is a gift. That gift would occur on December 31 of the year in which the income tax is paid (or, if earlier, immediately before the owner's death, or on the owner's renunciation of any reimbursement right for that year) unless the deemed owner is reimbursed by the trust during that same year. The amount of the gift is the unreimbursed amount of the income tax paid. The amount of the gift cannot be reduced by a marital or charitable deduction or by the exclusion for present interest gifts or gifts made for the donee's tuition or medical care. The gift, however, is an adjusted taxable gift.

The GRAT portion of the proposal would apply to all trusts created on or after the date of enactment. The portion of the proposal characterizing the grantor's payment of income taxes as a gift also would apply to all trusts created on or after the date of enactment. The gain recognition portion of the proposal would apply to all transactions between a grantor trust and its deemed owner or any other person occurring on or after the date of enactment. It is expected that the

legislative language providing for such an immediate effective date would appropriately detail the particular types of transactions to which the new rule does not apply.

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

The proposal would treat a trust's purchase of assets from, or interests in, a trust that is subject to GST tax (regardless of the selling trust's inclusion ratio), as well as a purchase of any other property that is subject to GST tax, as a change in trust principal that would require the redetermination of the purchasing trust's inclusion ratio when those assets (or trust interest) are purchased. Specifically, the inclusion ratio would be redetermined in the same way as in the case of a consolidation of trusts: the purchased assets would be included in the total value of the trust in the denominator of the applicable fraction, and only the portion of those assets excluded from GST tax immediately before the purchase would be added into the numerator of the fraction. The proposal similarly would apply to a trust's receipt of assets pursuant to a decanting of another trust (generally, the distribution of trust property to another trust pursuant to the trustee's discretionary authority to make distributions to, or for the benefit of, one or more beneficiaries of the decanted trust).

The proposal would apply to all such transactions occurring after the date of enactment.

#### Change the GST tax characterization of certain tax-exempt organizations

The proposal would ignore trust interests held by additional tax-exempt organizations for purposes of the GST tax.<sup>40</sup> As a result, the inclusion of such an organization as a permissible distributee of a trust would not prevent the occurrence of a taxable termination subject to GST tax.

The proposal would apply in all taxable years beginning after the date of enactment.

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

The proposal would require that the annuity payments made to charitable beneficiaries of a CLAT at least annually must be a level, fixed amount over the term of the CLAT, and that the value of the remainder interest at the creation of the CLAT must be at least 10 percent of the value of the property used to fund the CLAT, thereby ensuring a taxable gift on creation of the CLAT.

The proposal would apply to all CLATs created after the date of enactment.

#### Modify the tax treatment of loans from a trust

The proposal would treat loans made by a trust to a trust beneficiary as a distribution for income tax purposes, carrying out each loan's appropriate portion of distributable net income to the borrowing beneficiary. In addition, a loan to a trust beneficiary would be treated as a distribution

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<sup>40</sup> Specifically, the proposal would treat an organization described in section 501(c)(4) through (29) other than (c)(10) for GST tax purposes in the same way as an organization described in section 2055(a).

for GST tax purposes, thus constituting either a direct skip or taxable distribution, depending upon the generation assignment of the borrowing beneficiary. Within one year after the final payment made on the loan to the trust (whether or not that constitutes full satisfaction of the loan), a refund of the appropriate amount of GST tax (with interest only from the date of the claim for refund) could be requested to be refunded to the payor of the GST tax that was incurred when the loan was made.

To discourage borrowing from a trust by a person who is not a trust beneficiary but who is a deemed owner of the trust under the grantor trust rules, the proposal would create a special rule for GST tax purposes. Specifically, the repayment (regardless of the identity of the payor) of any loan made by a trust to a deemed owner or the spouse of a deemed owner would be treated as a new contribution to the trust by the borrowing deemed owner(s). Depending on the generation assignments of the trust's beneficiaries at the time of the repayment, this new contribution (like any other contribution) would utilize GST exemption of the borrower(s), generate a GST tax liability in the case of a direct skip on such borrower(s) or their respective estates, or increase the trust's inclusion ratio. Any GST tax payable on such a deemed direct skip that could not be collected from a deemed owner or a deceased deemed owner's estate (such as, if the time for collecting such a debt from a decedent has expired), would be payable by the trust itself.

The proposal includes a grant of regulatory authority to identify certain types of loans that would be excepted from the application of the proposal. This authority could be used to exempt short-term loans, which do not raise the same concerns. Similarly, other exceptions might be the use of real or tangible property for a minimal number of days.

The proposal would apply to loans made, as well as to existing loans renegotiated or renewed, by trusts after the year of enactment.

## **REVISE RULES FOR VALUATION OF CERTAIN PROPERTY**

### **Current Law**

#### Valuation of promissory notes

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

#### Valuation of partial/fractional interests in certain assets transferred intrafamily

The standard for determining the value of transferred property for transfer tax purposes is fair market value (FMV), which is defined as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of all relevant facts. In determining the FMV of various forms of partial interests, appraisers generally consider several factors, such as the form of ownership, restrictions on transferability, and prevailing market conditions. These factors can increase the value of a transferred interest (in the form of a premium) or decrease the interest’s value by applying valuation discounts for things like lack of marketability and lack of control. The Code disregards the effects on FMV of liquidation restrictions on controlled partnerships and corporations in limited circumstances but does not modify the FMV of partial interests in assets.

### **Reasons for Change**

#### Valuation of promissory notes

The rules for below-market loans allow taxpayers to take inconsistent positions regarding the valuation of loans to achieve tax savings. Typically, a taxpayer sells a valuable asset within their family for a promissory note carrying the minimum interest rate required to ensure that the loan is not taxed as a below-market loan for Federal income tax purposes. The taxpayer claims that the minimum interest rate is sufficient to avoid both the treatment of any foregone interest on the loan as imputed income to the lender and the treatment of any part of the transaction as a gift. However, in subsequently valuing that unpaid note for Federal estate tax purposes after the death of the taxpayer, the estate takes the position that the fair market value of the note should be discounted because the interest rate is well below the market rate at the time of the taxpayer’s death. In other words, the taxpayer relies on the statutory rules to assert that the loan is not below market for gift tax purposes at the time of the transaction but relies on the underlying economic characteristics later to assert the loan is below market for estate tax purposes.

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

#### Valuation of partial/fractional interests in certain assets transferred intrafamily

The valuation of partial interests in closely held entities, real estate and other personal property offers opportunities for tax avoidance when those interests are transferred intrafamily. Taxpayers regularly transfer portfolios of marketable securities and other liquid assets into partnerships or other entities, make intrafamily transfers of interests in those entities (instead of transferring the liquid assets themselves), and then claim entity-level discounts in valuing the gift. Similarly, taxpayers often make intrafamily transfers of partial interests in other hard-to-value assets such as real estate, art, or intangibles, allowing all family co-owners to claim fractional interest discounts.

While valuation discounts for lack of marketability and lack of control are factors properly considered in determining the FMV of such interests in general, they are not appropriate when families are acting in concert to maximize their economic benefits. In these cases, because the family often ignores the restrictions that justified the discounts, the claimed FMV of the transferred interest is below its real economic value, artificially reducing the amount of transfer tax due.

#### **Proposal**

##### Require consistent valuation of promissory notes

The proposal would impose a consistency requirement by providing that, if a taxpayer treats any promissory note as having a sufficient rate of interest to avoid the treatment of any foregone interest on the loan as income or any part of the transaction as a gift, that note subsequently must be valued for Federal gift and estate tax purposes by limiting the discount rate to no more than the greater of the actual rate of interest of the note, or the applicable minimum interest rate for the remaining term of the note on the date of death. The Secretary would be granted regulatory authority to establish exceptions to account for any difference between the applicable minimum interest rate at the issuance of the note and actual interest rate of the note. In addition, the term of any note (regardless of its rate of interest) would be shortened for purposes of valuing that note if there is a reasonable likelihood that the note will be satisfied sooner than the specified payment date and in other situations as determined by the Secretary.<sup>41</sup>

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

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<sup>41</sup> Permissible approaches could include without limitation treating the note as being short term regardless of the due date, valuing term loans as demand loans in which the lender can require immediate payment in full, or reducing the stated term to the earliest possible date on which the related property (such as an investment in a life insurance policy or arrangement) could be monetized by cashing in or selling the policy.

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

The proposal would replace section 2704(b) of the Code, which disregards the effect of liquidation restrictions on FMV, and instead provide that the value of a partial interest in non-publicly traded property (real or personal, tangible or intangible) transferred to or for the benefit of a family member of the transferor would be the interest's pro-rata share of the collective FMV of all interests in that property held by the transferor and the transferor's family members, with that collective FMV being determined as if held by a sole individual. Family members for this purpose would include the transferor, the transferor's ancestors and descendants, and the spouse of each described individual.

In applying this rule to an interest in a trade or business, passive assets would be segregated and valued as separate from the trade or business. Thus, the FMV of the family's collective interest would be the sum of the FMV of the interest allocable to a trade or business (not including its passive assets), and the FMV of the passive assets allocable to the family's collective interest determined as if the passive assets were held directly by a sole individual. Passive assets are assets not actively used in the conduct of the trade or business, and thus would not be discounted as part of the interest in the trade or business.

This valuation rule would apply only to intrafamily transfers of partial interests in property in which the family collectively has an interest of at least 25 percent of the whole.<sup>42</sup>

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

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<sup>42</sup> An attribution rule, that would be relevant only for purposes of determining whether the family's collective interest meets that threshold, would attribute to a person the maximum interest held through an entity or trust that could be allocated to that person. However, for purposes of determining the FMV of the family's collective interest, only interests held directly by a member of the family, interests held through a general partnership or wholly owned entity, and interests held in trusts either for the sole benefit of the family member or that are withdrawable or fully revocable by the family member, would be taken into consideration.

## **CLOSE LOOPHOLES**

### **TAX CARRIED (PROFITS) INTERESTS AS ORDINARY INCOME**

#### **Current Law**

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

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

#### **Reasons for Change**

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

#### **Proposal**

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

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

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

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

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

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

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

## **REPEAL DEFERRAL OF GAIN FROM LIKE-KIND EXCHANGES**

### **Current Law**

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

### **Reasons for Change**

The proposal would treat the exchanges of real property used in a trade or business (or held for investment) similarly to sales of real property, resulting in fewer distortions. The change would raise revenue while increasing the progressivity of the tax system. It would also align the treatment of real property with other types of property.

### **Proposal**

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

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

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

### **Current Law**

In general, a taxpayer recognizes gain or loss upon the disposition of an asset used in a trade or business. Such gain or loss can have the character of a capital gain or loss or an ordinary gain or loss according to various provisions of the Internal Revenue Code (Code). Generally, ordinary losses are deductible against a taxpayer's gross income, but capital losses may only offset capital gains.<sup>43</sup> Gains and losses from the sale or exchange of capital assets that have been held for more than one year generally are long-term capital gains and losses. A net capital gain (the excess of a net long-term capital gain over a net short-term capital loss) recognized by a noncorporate taxpayer is generally taxed at lower tax rates than those imposed on ordinary income. Corporations are taxed at the same rate for net capital gains and ordinary income.

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

The section 1250 property depreciation recapture rules have little or no effect on recharacterizing gain as ordinary income upon the disposition of section 1250 property because most section 1250 property is ineligible for the additional first-year bonus depreciation allowance and uses the straight-line depreciation method and applicable recovery period.<sup>44</sup>

Property used in a trade or business is not a capital asset, and gains and losses recognized from the sale, exchange, or involuntary conversion of such property are generally treated as ordinary income and ordinary loss. However, when held for more than one year, most depreciable property and other real property (for example, land) used in a trade or business are defined as "section 1231 property" and subjected to additional rules that determine whether a gain or loss from the sale, exchange, or involuntary conversion of such property is classified as capital or

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<sup>43</sup> Noncorporate taxpayers can deduct up to \$3,000 of the excess capital losses over capital gains.

<sup>44</sup> Section 1250 property that is "qualified improvement property" is eligible for the additional first year bonus depreciation allowance and accelerated regular depreciation allowances if placed in service after December 31, 2017. In general, qualified improvement property is an improvement made to the interior portion of a non-residential building that is placed in service after the building is first placed in service.

ordinary.<sup>45</sup> The sum of the gains on a taxpayer's section 1231 property (other than gains treated as ordinary income under the depreciation recapture rules) is compared to the sum of the losses on section 1231 property. If the taxpayer's section 1231 losses exceed its section 1231 gains for a taxable year, then such section 1231 losses and section 1231 gains are treated as ordinary losses and ordinary income, respectively. However, if the section 1231 gains exceed the section 1231 losses for a taxable year, then such gains and losses are generally treated as capital gains and capital losses, respectively. A taxpayer's aggregate net section 1231 gain for any taxable year is nevertheless treated as ordinary income to the extent that it does not exceed the amount of net section 1231 losses incurred in the five preceding taxable years (to the extent that such losses have not already been "recaptured" in this manner).

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

### **Reasons for Change**

For noncorporate taxpayers, most gains on buildings or other real property used in the taxpayer's trade or business are taxed at reduced rates because of the rules of sections 1250 and 1231 of the Code. When taxpayers claim depreciation deductions against ordinary income in excess of the actual decline in value of real property while paying tax on any gains at reduced rates, they are able to convert ordinary income into preferentially taxed capital income. This provides a tax subsidy for certain noncorporate businesses, especially real estate businesses.<sup>46</sup> Applying 100 percent depreciation recapture to the cumulative depreciation deductions on section 1250 property would eliminate this tax subsidy and opportunity for conversion of income. It would raise revenue while increasing the progressivity of the tax system.

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

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

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<sup>45</sup> Inventory, certain intangibles, and assets held for investment purposes are not considered property used in a trade or business and are not section 1231 property. However, gains and losses from the involuntary conversion of capital assets are also included as section 1231 gains and losses.

<sup>46</sup> Approximately 75 percent of section 1231 gains distributed to individual partners or shareholders by pass-through businesses are in the real estate sector.

## **Proposal**

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

The proposal would not apply to noncorporate taxpayers with adjusted gross income (AGI) below \$400,000 (\$200,000 for married individuals filing separate returns).<sup>47</sup> Partnerships and S corporations would be required to compute the character of gains and losses on business-use property (including section 1250 property, section 1245 property, and land) at the entity level and to report to entity owners the relevant amounts for ordinary income (loss), capital gain (loss), and unrecaptured section 1250 gain under both “new law” and “old law”. Those taxpayers with income of at least the threshold amount would use the “new law” amounts in completing their tax returns.

The proposal would be effective for depreciation deductions taken on section 1250 property in taxable years beginning after December 31, 2024, and sales, exchanges, involuntary conversions, or other dispositions of section 1250 property completed in taxable years beginning after December 31, 2024.

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<sup>47</sup> The taxpayer’s AGI is determined before applying the proposed change to 100-percent depreciation recapture of section 1250 property for purposes of calculating the \$400,000 (\$200,000 for married filing separate returns) threshold.

## **MODIFY DEPRECIATION RULES FOR PURCHASES OF GENERAL AVIATION PASSENGER AIRCRAFT**

### **Current Law**

Under the depreciation rules, the recovery period for airplanes not used in commercial or contract carrying of passengers or freight (including corporate jets) generally is five years and the recovery period for airplanes and other assets (including ground property but excluding helicopters) used in commercial or contract carrying of passengers or freight generally is seven years.

### **Reasons for Change**

The shorter recovery period for depreciating airplanes not used in commercial or contract carrying of passengers, but nevertheless used to carry passengers (such as corporate jets), provides a tax preference for these airplanes over airplanes used in a similar manner. To eliminate this preference, their recovery periods should be harmonized.

### **Proposal**

The proposal would define “general aviation passenger aircraft” to mean any airplane (including airframes and engines) not used in commercial or contract carrying of passengers or freight, but which primarily engages in the carrying of passengers (other than an airplane used primarily in emergency or emergency relief operations).

The proposal would increase the recovery period for depreciating general aviation passenger aircraft from five years to seven years. Correspondingly, for taxpayers using the alternative depreciation system, the recovery period for general aviation passenger aircraft would be extended to 12 years.

Any airplane not used in commercial or contract carrying of passengers or freight, but which is primarily engaged in non-passenger activities (e.g., crop dusting, firefighting, aerial surveying, etc.) and any helicopter would continue to be depreciated using a recovery period of five years (six years under the alternative depreciation system).

The proposal would be effective for property placed in service after December 31, 2024.

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

### Current Law

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

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

Qualifying distributions do not include the private foundation's contributions to either an organization controlled directly or indirectly by the private foundation's disqualified person(s),<sup>48</sup> or to another private nonoperating foundation, unless (a) not later than one year after the end of the taxable year in which the donee organization received the contribution, the receiving organization makes a distribution equal to the full amount of the contribution and the distribution is a qualifying distribution that is treated as being made out of corpus (or would be so treated if the donee organization were a private nonoperating foundation) and (b) the foundation making the contribution obtains adequate records or enough other evidence from the donee showing that the donee has made a qualifying distribution.

Qualifying distributions also do not include the private foundation's contributions to a Type I, Type II, or functionally integrated Type III supporting organization<sup>49</sup> if any of the private foundation's disqualified persons directly or indirectly control the organization or a supported organization of such organization.

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

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

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<sup>48</sup> Disqualified persons are defined generally as substantial contributors to the foundation, foundation managers, owners of more than 20 percent of certain entities that are substantial contributors to the foundation, family members of the foregoing, and certain entities in which the foregoing, alone or together, own more than 35 percent.

<sup>49</sup> A supporting organization is classified as a Type I, Type II or Type III supporting organization based on the type of relationship it has with its supported organization(s). Type III supporting organizations are further classified as functionally integrated and non-functionally integrated. For more information, see section 509(a)(3) and the regulations thereunder.

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

### **Reasons for Change**

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

### **Proposal**

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

The proposal would be effective after the date of enactment.

## **EXCLUDE PAYMENTS TO DISQUALIFIED PERSONS FROM COUNTING TOWARD PRIVATE FOUNDATION PAYOUT REQUIREMENT**

### **Current Law**

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

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

Paying compensation or reimbursing expenses by a private foundation to a disqualified person is generally an act of self-dealing. The general rule does not apply, however, to the extent that the payments, which cannot be excessive, are for personal services that are reasonable and necessary to carry out the foundation’s exempt purposes.

### **Reasons for Change**

Some private foundations meet their entire payout requirement by hiring family members. The intent of the payout requirement is to ensure private foundations use at least 5 percent of the total fair market value of their non-charitable use assets from the preceding taxable year for charitable purposes, such as grants to needy persons or to operating charities. Allowing payments to disqualified persons to count towards a private foundation’s payout requirement does not meet this intent to directly further charitable purposes.

### **Proposal**

Under the proposal, paying compensation or reimbursing expenses by a private foundation to a disqualified person (other than a foundation manager of such private foundation who is not a member of the family of any substantial contributor) is not a qualifying distribution that satisfies the payout requirement. The self-dealing rule would not change, so a private foundation could still pay reasonable compensation to a disqualified person for personal services that are reasonable and necessary to carry out the foundation’s exempt purposes; these payments would just not count toward the payout requirement.

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

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

### **Current Law**

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

If a taxpayer invests an amount of eligible gain in a Qualified Opportunity Fund (QOF) and elects deferral, that amount of eligible gain is excluded from the taxpayer's income for the year that the gain is realized. Pursuant to statute, recognition of that gain is deferred until December 31, 2026, or an earlier date on which there occurs any of various inclusion events.<sup>50</sup>

### **Reasons for Change**

Although deferral for all taxpayers must end no later than December 31, 2026, inclusion events may require some taxpayers to recognize the deferred gain before that date. In many cases, the only manifestation of the inclusion event on the taxpayer's return is the inclusion of the deferred gain in gross income. Thus, inclusion events that occur prior to December 31, 2026, may not be readily identifiable on the taxpayer's return and there is an increased risk that the IRS may be barred from assessing a deficiency arising from the inclusion event by the expiration of the typical three-year statute of limitations.

### **Proposal**

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

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

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<sup>50</sup> Examples of inclusion events include certain events (a) that reduce a taxpayer's direct equity interest in a QOF, (b) in which a taxpayer receives property with respect to its interest in a QOF and the event is treated as a distribution for Federal income tax purposes, (c) in which a taxpayer claims a loss for worthless stock or otherwise claims a worthlessness deduction with respect to its interest in a QOF, and (d) in which an entity certified as a QOF loses its status as a QOF.

## **IMPOSE OWNERSHIP DIVERSIFICATION REQUIREMENT FOR SMALL INSURANCE COMPANY ELECTION**

### **Current Law**

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

The election is available to non-life insurance companies that receive during the taxable year net written premiums (or, if greater, direct written premiums) that do not exceed the threshold amount for that year. The threshold amount for taxable years beginning in 2024 is \$2.80 million, an amount that is indexed annually for inflation. For this test, the electing company is treated as receiving the (net or direct) written premiums received by all other companies that are members of the same controlled group as the company for which the determination is being made. For this purpose, and for that of meeting the first diversification requirement (described below), a parent-subsidary controlled group is defined by using a more-than-50 percent ownership threshold.

An insurance company must meet at least one of two ownership diversification requirements to qualify for an election. A company meets the first diversification requirement if no more than 20 percent of its net written premiums (or, if greater, direct written premiums) is attributable to any one policyholder. For this purpose, all policyholders that are related (within the meaning of section 267(b) or 707(b) of the Internal Revenue Code (Code)) or that are members of the same controlled group of corporations are treated as a single policyholder. The cited relatedness standard generally includes close family relationships (siblings, spouses, ancestors, and lineal descendants), certain trust fiduciary relationships, and certain corporate and partnership relationships (using a more-than-50 percent ownership threshold as an indicator of relatedness). In addition, any policyholder of an underlying direct written insurance contract that is reinsured by the potential electing company is treated as a policyholder of that company for the purpose of this test.

If the first diversification requirement is not met, the second requires that no person holding, directly or indirectly, an interest in the electing insurance company and who is a spouse or lineal descendent of an individual holding an interest in a business or in other assets being insured by the insurance company has a greater percentage ownership interest in the insurance company than he or she has in the business or assets being insured.

## **Reasons for Change**

The alternative tax regime is intended to allow electing insurance companies to provide more affordable insurance coverage to policyholders. However, some taxpayers have worked with promoters to abuse the alternative regime by benefitting themselves or related parties without providing insurance or by providing minimal insurance at very high premium rates unrelated to the expected losses associated with the insured risks. In these cases, taxpayers, or related parties, usually own both an electing entity characterized as an insurance company and one or more businesses paying amounts characterized as insurance premiums to the electing entity. Each business purchasing a policy from the electing entity claims tax deductions for the amounts paid and characterized as premiums. The electing entity, however, does not include these amounts in gross income and does not deduct any underwriting costs (insurance claims and associated expenses) in computing its taxable income.

In many cases identified in audit by the Internal Revenue Service (IRS), the arrangements characterized as insurance do not satisfy the requirements for insurance contracts under Federal income tax law. The amounts characterized as insurance premiums in these cases are unreasonably high, resulting in large amounts of untaxed underwriting income that are not needed to pay policyholder claims and related expenses. The electing entity often uses these funds for purposes unrelated to the business of insurance, such as making loans to, or purchases for, the personal or business use of related persons, including policyholders.

In several recent decisions, the U.S. Tax Court determined that certain fact patterns with these attributes do not represent insurance transactions and denied the claimed deductions. In some cases, the Court imposed penalties or required the electing entity to include the alleged premiums in income.<sup>51</sup> Nevertheless, auditing and litigating such arrangements consumes significant scarce tax administration resources, and a statutory remedy would be more effective in addressing the pervasiveness of abuse.

Because the abusive fact patterns described above are most likely to occur if related parties own both the electing entity and the entities paying the amounts characterized as premiums, an effective ownership diversification requirement would appropriately address this abuse. The current diversification requirements (described above) are ineffective because the industry has been able to develop ownership and payment structures that may avoid those requirements.

## **Proposal**

The proposal would curtail abuse by certain companies while preserving the alternative tax election for those companies that use this tax benefit to reduce the cost of insurance. Under the

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<sup>51</sup> Avrahami v. Commissioner, 149 T.C. 144 (2017); Swift v. Commissioner, T.C. Memo. 2024-13 (2024) (accuracy related penalty sustained and company would be required to recognize the premiums it received as income); Keating v. Commissioner, T.C. Memo 2024-2 (2024) (accuracy related penalty also sustained); Caylor Land & Development, Inc. v. Commissioner, T.C. Memo. 2021-30 (2021) (accuracy related penalty also sustained); Syzygy Ins. Co., Inc. v. Commissioner, T.C. Memo 2019-34 (2019) (company also required to recognize the premiums it received as income).

proposal, to qualify for the alternative tax regime, an insurance company would be required to meet the following conditions:

1. Qualify as a non-life insurance company;
2. Have net written premiums (or, if greater, direct written premiums) for the taxable year that do not exceed a statutorily determined amount (\$2.80 million in 2024); and
3. Have no more than 20 percent of the assets or the voting power or value of the stock of such company owned, attributed, or constructively owned by: (a) a policyholder of such company or an owner of such policyholder, or (b) collectively by a policyholder or owner of a policy holder and one or more persons related to that policyholder or owner.

Under requirement (2), the proposal would continue the current law requirement to attribute premiums received by members of a controlled group including the potential electing company to that company, with the controlled group determined using a more-than-50 percent ownership threshold.

For requirement (3), a policyholder would include any person that conducts a trade or business and treats amounts paid under the relevant insurance contract as insurance premiums for Federal income tax purposes. An owner of a policyholder would be any person with an ownership interest in the policyholder, determined based on constructive ownership and attribution rules found elsewhere in the Code. Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust would be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries. Grantor trusts would be treated as owned by the grantors, and “stock” would include any certificate entitling the holder to voting power in a mutual insurance company. An individual would be considered as owning stock owned, directly or indirectly, by or for his or her family, which would include any sibling, ancestor, or lineal descendent of the individual’s parents, and the spouses of such family members.

The proposal would continue to maintain the current law relatedness standards under sections 267(a) and 707(b), including the more-than-50 percent ownership threshold for corporations and partnerships, but would use the broader definition of family members described in the previous paragraph for this purpose. The proposal would also maintain the current law rule that identifies as a “policyholder” of the company any policyholder of an underlying direct written insurance contract that has been reinsured by the company.

Finally, the proposal would add an anti-abuse rule, stating that a company would fail to meet requirement (3) for the taxable year in the case of a transaction or arrangement that directly or indirectly shifts payments (including premiums) between policyholders of companies that would otherwise be electing companies. The Secretary would be authorized to issue regulations or other guidance with respect to such transactions or arrangements (including the use of a fronting company, an intermediary, cross insurance, reinsurance, or a pooling arrangement designed to facilitate the shifting of payments in order to allow companies to meet requirement (3)).

The Secretary would also be authorized to issue guidance regarding possible requirements for new elections, revocation of prior elections, and related tax consequences for companies that previously qualified for the election but do not qualify under the new standard.

The two ownership diversification requirements under current law would be repealed.

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

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

### **Current Law**

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

Interest paid or accrued on policy loans or other indebtedness with respect to life insurance, endowment, or annuity contracts owned by a business generally is not deductible unless the contract insures the life of a current key person of the business and the amount of the indebtedness does not exceed \$50,000 per key person insured. The amount of such deductible interest is limited to an amount determined using an average corporate bond yield. A key person is an officer or 20 percent owner of the business, but the number of key persons is capped at between five and 20 individuals, depending on the size of the business. All members of a controlled group (defined as a single employer under section 52(a) or (b) or section 414(m) or (o)) are treated as a single taxpayer. This interest-disallowance rule applies only to the extent that the relevant indebtedness can be traced to a life insurance, endowment, or annuity contract.

The interest deductions of a business other than an insurance company are reduced to the extent the general interest expense of the business is allocable to unborrowed policy cash values of life insurance, endowment, or annuity contracts. This allocation is based on the ratio of the company's average unborrowed policy cash values to average total assets. The provision does not apply to a policy or contract held by a natural person unless the business (other than a sole proprietorship) is directly or indirectly a beneficiary under the policy, nor does it apply to annuity contracts not held by natural persons, the income of which is subject to current taxation. For partnerships and S corporations, the provision applies at the entity level. All members of a controlled group of corporations (as defined above) are treated as a single taxpayer. The provision generally applies before interest expense is capitalized into the cost of produced property under the uniform capitalization rules of the Internal Revenue Code (Code) but generally after other limitations on interest deductions are imposed. Interest expense which has been disallowed as a deduction due to section 265 (i.e., interest on indebtedness incurred or continued to purchase or carry tax-exempt securities) is not taken into account under this provision, and the taxpayer's average total assets taken into account under this provision is reduced by the amount of such indebtedness.

An exception to the pro rata interest-disallowance rule applies with respect to contracts that cover individuals who were officers, directors, employees, or 20 percent owners of the trade or business at the time the individual was first covered by the contract. There is no limit to the number of such excepted individuals. The unborrowed cash values of excepted contracts are not taken into account in either the numerator or the denominator of the interest allocation formula.

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

### **Reasons for Change**

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

### **Proposal**

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

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

## **MODIFY RULES FOR INSURANCE PRODUCTS THAT FAIL THE STATUTORY DEFINITION OF A LIFE INSURANCE CONTRACT**

### **Current Law**

A life insurance contract under the applicable law (typically the insurance law of the domestic or foreign jurisdiction controlling the issuance and interpretation of the contract) is generally treated as an insurance contract under the Internal Revenue Code (Code). However, to qualify for most tax benefits of life insurance policies, the contract must meet the Code's definition of a life insurance contract by satisfying one of two tests that serve to limit a contract's cash value relative to its death benefit.

In general, investment earnings credited to the cash value of a qualifying life insurance policy are taxable only if the income is deemed distributed to the policyholder. Cash distributions from a life insurance contract (other than policy loans, which are generally not regarded as distributions) are generally treated as coming first from the investment in the contract (equal to aggregate premiums paid, less aggregate untaxed distributions); that is, distributions are treated first as an untaxed return of basis. However, if a life insurance contract is determined to be a modified endowment contract (because it is funded too quickly), distributions are deemed to come first from the excess of a contract's cash value over investment in the contract, and to that extent included in gross income. Policy loans made to any person from a modified endowment contract are taxed in the same way as policy distributions, but investment in the contract is increased to the extent such loans are treated as taxable. Nevertheless, accumulated investment earnings of a qualified life insurance contract (including a modified endowment contract) are usually exempt from tax if they are paid as a component of death benefits upon the insured's death.

In contrast, a policyholder of a life insurance contract under the applicable law that has failed both statutory tests (hereafter, a "failed contract") is subject to tax on the "income on the contract" that has accrued during the policyholder's taxable year, regardless of whether any policyholder distributions have occurred. If a life insurance contract under applicable law satisfies the definition of life insurance under the Code, but becomes a failed contract during a taxable year, the income on the contract for all prior taxable years is treated as received or accrued during that taxable year.

The statute defines "income on the contract" as the excess of (a) the sum of the increase in the contract's net surrender value during the taxable year and the cost of insurance protection provided under the contract during the taxable year over (b) any policy premiums paid during the taxable year. A contract's net surrender value is the amount currently payable under the contract, determined without regard to any policy loan, but net of any surrender charges. In the absence of relevant regulations, the cost of insurance protection equals the mortality charge (if any) stated in the contract, which generally depends on the contract's amount at risk (the difference between the contract death benefit and its gross investment or asset value). Premiums paid are measured net of any untaxed distributions of cash received by the policyholder. For a failed contract, the excess of any amount paid by reason of death of the insured over the policy's net surrender value is exempt from tax. A failed policy's net surrender value typically represents net premiums paid

and previously taxed, but undistributed, investment earnings (the contract's adjusted basis); therefore, these amounts also bear no tax if paid out as a death benefit.

### **Reasons for Change**

U.S. State insurance non-forfeiture laws generally require that policyholders have access to income credited to their cash value life insurance policies, and policyholders, in many cases, want to maximize their ability to access their policies' values via withdrawals of cash values, loans, or policy surrenders. In recent decades, however, some foreign insurance companies have designed contracts, typically known as "frozen cash value" (FCV) contracts, that do not allow access to amounts credited to the contract that are in excess of the sum of gross premiums paid, less amounts withdrawn or loaned. Thus, the net surrender value for these contracts never exceeds net premiums paid. An FCV contract is usually a flexible premium life insurance contract, whose supporting assets reflect premiums paid, accumulated earnings, and any realized and unrealized appreciation or depreciation of those assets. An FCV contract is unlikely to have surrender charges, and its death benefit will generally equal the value of the supporting assets plus a small amount at risk, which reportedly equals between 2.5 percent and 10 percent of the policy's assets, although certain contracts may have a smaller (or even zero) amount at risk.

FCV contracts are designed to be life insurance contracts under the applicable foreign law and failed contracts under the Code. A U.S. policyholder of such an FCV contract is subject to tax on the policy's "income on the contract" (which will typically be zero or very low), and the contract's death benefit in excess of the net surrender value is tax-free to a U.S. beneficiary. Because the increase in the net surrender value of an FCV contract is attributable only to premium payments, "income on the contract" is limited, at most, to the cost of insurance protection. But this cost of insurance protection is determined by multiplying the FCV contract's amount at risk by a mortality rate, so the amount of tax due is relatively small. Increases in a contract's asset value are not included in taxable income because they are either offset by a payment of premiums during the taxable year or are not part of a contract's net surrender value. Furthermore, proponents of FCV contracts argue that both partial withdrawals and policy loans received during the life of the insured are nontaxable to the extent they are limited to premiums paid and therefore should be deemed to be a return of the contract's basis.

By taxing the excess of a contract's net surrender value over the premiums paid, the rules governing the taxation of failed life insurance contracts were intended to fully tax to the policyholder the earnings and gains accruing on a failed contract's underlying investments, as well as the mortality charges (which are generally designed to be paid out as otherwise tax-excluded contract death benefits). These outcomes are negated by FCV contracts, since these contracts manage to avoid virtually all income tax expected to be levied on earnings by excluding them from the contract's net surrender value.

### **Proposal**

Rules governing failed life insurance contracts would be modified in several respects to ensure that taxation occurs as intended with respect to FCV contracts. First, the current law definition of income on the contract for a failed contract would be modified by substituting "net investment

value” for net surrender value. A failed contract’s net investment value would be defined for a given date as the amount representing the contract’s death benefit, less the contract’s amount at risk and any specific charges that might be imposed upon a contract’s surrender, at that date. Any policy loan would be disregarded in the determination of a contract’s net investment value. This change would mean that the policyholder of any failed contract (including FCV contracts) would be subjected to current taxation on the earnings credited to that contract.

Second, amounts distributed and policy loans from a failed contract would be deemed to be amounts distributed or loaned under a modified endowment contract. For this purpose, the definition of investment in the contract would be amended to include amounts of income on the contract that have been taxed prior to the distribution or loan date, other than amounts equal to the cost of life insurance protection. (These last amounts, while taxed, do not accrue to the value of a contract’s net investment value.) A failed contract’s adjusted basis for other Code purposes would be defined as equal to its investment in the contract.

Third, the excess of the amount paid by the reason of the death of the insured over the net investment value of the contract would be deemed to be paid under a life insurance contract for purposes of determining the exclusion amount of death benefit proceeds and for purposes of estate and gift taxes.

The proposal would be effective for taxable years beginning after December 31, 2024 for life insurance contracts issued under applicable law on or after the day following the date of publication of this [\*General Explanation of the Administration’s Fiscal Year 2025 Revenue Proposals\*](#). Thus, all earnings and gains credited to failed contracts owned by U.S. persons that were issued after this publication date would be included in the U.S. policyholder’s “income on the contract” for taxable years beginning after December 31, 2024. For any qualifying life insurance contracts issued after the publication date that become failed contracts in later years, any prior amounts of untaxed investment value would become taxable in the year of contract failure. Any substantial modification of an existing life insurance or annuity contract, or exchange of one such contract for another, would be treated as the issuance of a new contract for this purpose. Future withdrawals of cash value from a newly failed contract and any associated policy loan would be deemed funded from the policy’s investment in the contract and would not be treated as a taxable distribution.

## LIMIT TAX BENEFITS FOR PRIVATE PLACEMENT LIFE INSURANCE AND SIMILAR CONTRACTS

### Current Law

The Internal Revenue Code (Code) provides significant tax benefits to policyholders and beneficiaries of life insurance and annuity contracts. In general, investment earnings credited to the cash value of a life insurance or annuity contract are taxable only if the income on the contract is deemed distributed to the policyholder. Thus, such earnings enjoy a deferral of tax liability not available if the invested assets supporting the insurance or annuity contract were held outside of the contract.

Cash distributions from a life insurance contract (other than policy loans, which are generally not regarded as policy distributions) are generally treated as coming first from the “investment in the contract” (generally equal to aggregate premiums paid, less aggregate untaxed distributions received by the policyholder); that is, distributions are treated first as an untaxed return of premiums. However, if a life insurance contract is determined to be a “modified endowment contract” (MEC) because it is funded too quickly, distributions are deemed to come first from the excess of a contract’s cash value over its investment in the contract, and, to that extent, are included in taxable income. With some exceptions, an additional 10 percent tax is levied on taxable amounts received from a MEC.<sup>52</sup> Policy loans and assignments or pledges of any portion of the policy value made to any person from a MEC are taxed in the same way as cash distributions, but investment in the contract is increased to the extent such loans are taxable.

For annuity contracts held by a natural person (or trust/agent for the benefit of a natural person), amounts received prior to the annuity starting date (the first day of the first period for which an amount is received as an annuity) are taxed in the same manner as distributions from a MEC, except that loans and pledges of cash value to or by individuals (rather than any person) are treated as distributions. Amounts received after the annuity starting date, but not paid as an annuity, are included in taxable income, while periodic payments received as an annuity after the annuity starting date generally are allocated between income on the contract and investment in the contract, and the portion allocated to income is taxable. With some exceptions, an additional 10 percent tax is levied on taxable amounts received from an annuity.<sup>53</sup>

An annuity contract not held by a natural person generally is not treated as an annuity contract under the Code’s income tax provisions (other than for purposes of the taxation of insurance companies). Consequently, all income earned on such a contract (other than amounts reflecting contract surrender charges) is taxed as ordinary income to the policyholder in the year it is credited to the contract’s cash value. There are exceptions to this treatment, including for immediate annuities. Furthermore, the 10 percent additional tax on taxable annuity amounts is not levied on annuity contracts subject to annual taxation of credited earnings.

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<sup>52</sup> Distributions to taxpayers aged 59½ or older, those attributable to the taxpayer becoming disabled, and those made in the form of an annuity for the life or life expectancy of the taxpayer are excepted from the MEC penalty tax.

<sup>53</sup> The annuity penalty tax exceptions include those distributions excepted under the MEC penalty tax, those made on or after the death of the contract holder or the primary annuitant, distributions from qualified retirement plans or contracts, and those made under a qualified funding asset or under an immediate annuity contract.

Accumulated investment earnings of a life insurance contract (including those of a MEC) are generally exempt from tax if they are paid by reason of the death of the insured. Life insurance held through a properly structured irrevocable life insurance trust (or otherwise deemed not to be owned by the insured) is not included in the insured's gross estate and thus death benefits for such policies are not subject to estate and generation-skipping transfer taxes.

Certain life insurance and annuity contracts offer a policyholder the opportunity to invest a contract's supportive assets in one or more managed investment portfolios. Such investment options are made available exclusively to policyholders by the insurance company. These portfolios may produce variable investment returns that determine adjustments to a policy's cash value and, in the case of life insurance, to its death benefit. For such variable contracts, the investment assets usually are held in one or more separate accounts that are legally segregated from an insurance company's general asset account. Although the insurance company is the owner of the separate account assets for legal and tax purposes, these assets cannot be accessed by the company other than to pay the variable contracts' premiums, fees, and benefits.

The investment portfolios of certain variable contracts must meet diversification requirements specified in the Code, or the policy will cease to be treated as a life insurance or annuity contract under the Code. In that case, income earned on the separate account assets is treated as taxable income received by the contract owner. Also, under the "investor control doctrine," policyholders must not have direct or indirect control of the managed portfolio investments underlying their contract, or they (rather than the insurance company) will be treated as the owner of those investments for tax purposes.

Variable contracts under which policyholders bear the risk of investment loss are subject to Securities and Exchange Commission (SEC) regulation as securities if they are sold or marketed in the United States. However, because registering products and maintaining the related compliance obligations are time consuming, expensive, and may limit the ability to offer certain investment options, life insurance companies only register with the SEC standardized products that offer a relatively narrow set of investment options and are marketed widely to the general public in the United States. Unregistered products may only be sold on the condition that their purchasers certify that they meet certain SEC-specified "accredited investor" or "qualified purchaser" definitions. These definitions are intended to ensure that the targeted policyholders are financially able and sophisticated enough to bear the investment risks of unregistered products.

### **Reasons for Change**

As described above, investments made through a life insurance or annuity contract benefit from significant deferral or exclusion tax benefits relative to investments held directly without an insurance or annuity "wrapper." For life insurance, the presumed public policy justification for these tax advantages is to encourage the purchase of insurance for the support of individuals who lose their source of income due to a death. Annuities are intended to provide a stream of income and, in the case of life annuities, insurance protection against outliving income available from one's invested assets.

The tax advantages of life insurance are not intended to provide opportunities for the wealthiest taxpayers to earn substantial tax-free or tax-deferred investment income. Nevertheless, some insurance companies offer customized “private placement” life insurance (PPLI) and annuity (PPA) contracts that do exactly that. Companies selling PPLI contracts generally require annual premiums on such policies of at least \$1 million for several years, and often substantially more. Consequently, these policies are offered to only very high net worth individuals or as business-owned life insurance. Most individual PPLI policyholders reportedly have a net worth of \$20 million or more, with \$10 million or more in liquid assets.

PPLI and PPA contracts allow very affluent purchasers to select from an array of investment options that are not accessible generally to purchasers of registered policies. For example, PPLI and PPA separate accounts may be invested in unregistered hedge funds and private equity funds or in more exclusive portfolios closely tailored to the investment preferences of private placement policyholders (possibly including real estate and other assets deemed attractive to the specific investor).

PPLI contracts are highly investment-oriented policies, provide legally minimal life insurance protection relative to the amounts invested, and are available only to the wealthiest taxpayers to whom income tax and/or estate tax benefits are far more important than the provision of insurance for their heirs. PPLI is also distinguishable from other life insurance products because more than half of the value of such policies is held by institutions, such as large corporations, and not individuals. This type of policyholder uses PPLI death benefits and other distributions to fund executive compensation, employee benefits, and other corporate purposes unrelated to the impact on the business from the death of the insured.

Some U.S. individuals purchase investment-oriented contracts outside of the United States. These variable contracts are regulated as life insurance under foreign law and may permit even greater product customization than is available generally in the United States. For example, foreign law may permit the payment of in-kind premiums, rather than only payment in cash or cash-equivalents, whereby the contributed assets are held as part of the contract’s separate account investment. Indeed, an investment manager might purchase assets directly or indirectly from the policyholder or from related persons or businesses, thus allowing policyholders to fund their variable contracts with desired idiosyncratic investments. U.S. State insurance regulation generally does not permit in-kind premium payments. Variable contracts funded by policyholder assets may violate the investor control doctrine, and an enhanced ability to identify such contracts would be helpful to tax administration.

Given the relatively minimal life insurance justification for PPLI contracts and the predominant investment orientation of PPLI, PPA, and similar contracts, such contracts should not give rise to the same tax benefits traditionally provided to life insurance and annuities under the Code. Accordingly, the proposal described below ensures that all earnings on PPLI, PPA, and similar contracts are ultimately taxable, and that tax deferral is limited and discouraged through a penalty tax, while preserving a tax exemption for the pure life insurance benefits (amounts paid in excess of a contract’s cash value) received under PPLI contracts.

## **Proposal**

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

### **Tax treatment of Covered Contracts**

Covered Contracts would be subject to the following tax consequences:

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

The Secretary would be authorized to issue regulations regarding the definition of the Covered Contract’s investment value to prevent avoidance of the purposes of these rules, including regulations which ensure that such value, as of any time, properly reflects the value of any underlying investments with respect to such Covered Contract as of such time.

2. Amounts paid after the annuity starting date (if applicable) would be treated as under current law.
3. Amounts paid from a life insurance contract by reason of the insured’s death would be taxable as ordinary income, but only to the extent the beneficiary’s share of the contract’s investment value exceeds the beneficiary’s share of the contract’s investment in the contract. A contract’s investment value and investment in the contract would be allocated to multiple beneficiaries in proportion to the allocation of the death benefit itself to those beneficiaries.
4. An additional tax equal to 10 percent of any taxable distribution from a Covered Contract would be assessed to account for the tax deferral benefits accorded Covered Contracts. The current Code exceptions to the 10 percent penalty tax that apply to taxable amounts received from a MEC or an annuity would not apply to Covered Contracts.
5. A Covered Contract’s investment in the contract, as well as its basis for determining taxable gain or loss, would be determined as under current law but would be reduced by

the amount of any mortality charges that have been assessed against the contract's investment value.

### Definition of Covered Contracts

The following categories of variable contracts (defined below) would be Covered Contracts subject to the tax treatment described above and the reporting requirements described below:

1. Any PPLI or PPA contract, defined as a variable contract subject to SEC regulation as a security that is not a registered product with the SEC, with respect to which the purchaser, as a condition of purchase, must have sufficient income and wealth to qualify (or can otherwise qualify) as an accredited investor or qualified purchaser under SEC regulations at the time of purchase.
2. Any variable life insurance contract any of whose premiums are paid, directly or indirectly, in kind rather than in cash.
3. Any variable life insurance contract whose underlying assets include assets purchased, directly or indirectly, from the policyholder, persons related to the policyholder, or a business or other entity in which the policyholder or a related person has more than a de minimis ownership interest.
4. Any variable life insurance contract that, in combination with contracts owned by persons related (directly or indirectly) to the contract's policyholder, owns an interest in a separate account of an insurance company, and the cash value of the related contracts, in the aggregate, represents at least 5 percent of the value of any distinct investment option whose assets are accounted for in that separate account.<sup>54</sup>
5. A variable life insurance contract issued outside of the United States, if any of the investment assets supporting the contract, if supporting a contract sold or marketed in the United States, would cause that contract to be salable only to an accredited investor or qualified purchaser and subject to SEC regulation as a security.

For purposes of the proposal, a "variable contract" would be defined as any life insurance or annuity contract for which the amount of the covered insurance company's obligations to the contract holder depends in whole or in part (by law, regulation, or the terms of the contract) on the value of assets that are designated to support the contract.

The following annuity contracts would not be Covered Contracts:

1. A contract held by a nonnatural person that is subject to annual taxation of earnings under current law.

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<sup>54</sup> A life insurance separate account or subaccount with this level of ownership concentration is an exclusive portfolio likely closely tailored to the investment preferences of a small group of policyholders, and the participating contracts are therefore similar in nature to the most investment-oriented PPLI contracts.

2. A contract issued under a qualified retirement plan or contract (including a tax-exempt pension trust, individual retirement account, or individual retirement annuity).

For defining a Covered Contract, the relatedness standard would generally include close family relationships (siblings, ancestors, and lineal descendants of the parents of the tested individual or the individual's spouse, and spouse of the individual or of any of the described relatives), certain trust fiduciary relationships, and certain corporate and partnership relationships (using a more-than-50 percent ownership threshold as an indicator of relatedness).

The Secretary would be authorized to issue regulations to prevent avoidance of variable contract status, and to prevent avoidance of Covered Contract status by conduit arrangements or otherwise. The Secretary also would be authorized to issue regulations or other guidance identifying other categories of investment-oriented variable life insurance contracts issued outside of the United States and not subject to SEC registration requirements that are similar in nature to PPLI and should thus be subject to the same tax treatment for U.S. tax purposes.

#### New reporting requirements for Covered Contracts

The Secretary would be authorized to require reporting by insurance companies and policyholders as necessary to ensure that payments from Covered Contracts are identified and taxed appropriately, including information on policy distributions and premiums. Insurance companies and policyholders would be subject to appropriate penalties for noncompliance with these reporting requirements. In addition, if a payment recipient omits a taxable amount attributable to a distribution from a Covered Contract from the recipient's reported gross income on an income tax return, the associated income and penalty taxes would be assessable at any time within six years after the return was filed.

The proposal would be effective for taxable years beginning after December 31, 2024, for Covered Contracts issued under applicable law on or after the day following the date of publication of this [\*General Explanation of the Administration's Fiscal Year 2025 Revenue Proposals\*](#). Any substantial modification of an existing life insurance or annuity contract, or exchange of one such contract for another, would be treated as the issuance of a new contract for this purpose.

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

### **Current Law**

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

#### **Policy acquisition expenses**

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

#### **Discounting of unpaid losses**

Insurance companies must discount their unpaid loss reserves on property and liability insurance contracts to reflect the fact that unpaid claims and other incurred losses may not be paid for several years into the future. Certain "short-tail" lines of business have relatively short payout profiles. These lines of business include, for example, auto physical damage, warranty insurance, financial guarantee insurance, and certain special property lines of business. Under the tax law, these lines are treated as paying out virtually all their claims by the end of the third year after the accident year (i.e., the year in which losses are incurred). Other lines of business, such as workers' compensation and liability insurance lines, are assumed to pay out claims over much longer periods – currently, up to 17 years after the accident year in the case of workers' compensation claims. Consequently, the average discounting of the unpaid losses under these "long-tail" lines of business is much deeper than the discounts applied to the unpaid losses of "short-tail" lines. Nonproportional reinsurance and international lines of business are deemed to be long-tail lines under the accounting rules promulgated by the National Association of

Insurance Commissioners and, prior to enactment of the TCJA, were treated as long-tail lines for purposes of the unpaid loss discounting tax rules. The TCJA significantly modified the discounting rules, mainly by establishing a different method for determining the applicable interest rates and by lengthening the expected claim payment patterns for long-tail lines of business. However, in modifying the Code to enact these changes, the drafters deleted statutory provisions that had addressed the treatment of the nonproportional reinsurance and international lines of business. Under the revised statute, these lines of business must be treated as short-tail lines of business, and Department of the Treasury regulations now consider them as such – even though there is no legislative history to indicate that this change was intended by Congress.

The payment patterns used to compute discount factors are redetermined every five years. Those patterns used for the most recent “determination year” were developed using insurance company annual statement data for the year 2019 and used first to discount unpaid losses incurred in 2022.

### **Reasons for Change**

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

Proper identification of the international and nonproportional reinsurance lines of business as long-tail lines of business would result in payment patterns for those lines of business that are as long as 10 to 14 years after the accident year. While the TCJA discounting drafting error has had relatively minor consequences for aggregate revenue, it nonetheless inappropriately favors these lines of business by reducing the degree of discount for their unpaid losses and provides an unwarranted and unintended deferral of income recognition.

### **Proposal**

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

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

The proposal would be effective as if it had been a part of the original TCJA and would be treated as a change of accounting method initiated by the taxpayer with the consent of the Internal Revenue Service for the taxable year beginning in 2025.

The second technical correction would include the international and nonproportional reinsurance lines of business in the list of long-tail lines of business that are explicitly identified in the statute. This list currently includes various liability lines of business, medical malpractice insurance, workers' compensation insurance, and multiple peril lines.

The proposal would be effective for taxable years beginning after December 31, 2024, for losses incurred and salvage recoverable in accident years beginning after 2024. New loss payment patterns for the international and nonproportional reinsurance lines of business would be determined as if they had been promulgated for the 2022 determination year under the rules proposed here.

## **DEFINE THE TERM “ULTIMATE PURCHASER” FOR PURPOSES OF DIESEL FUEL EXPORTATION**

### **Current Law**

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

### **Reasons for Change**

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

### **Proposal**

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

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

## **LIMIT THE DEDUCTION FOR THE TRANSFER OF PROPERTY TO THE VALUE OF PROPERTY ACTUALLY INCLUDED IN INCOME**

### **Current Law**

Current law limits an employer's deductions for the transfer of property, such as employer stock, in connection with the performance of services to the "amount included" in the person's gross income. Internal Revenue Service (IRS) regulations clarify that the deduction is limited to the amount *actually* included in the service provider's income, but the regulations provide a safe harbor that deems the amount that is reported by the employer on the applicable annual information return (e.g., Form W-2, Wage and Tax Statement, for an employee) to be included in the service provider's income for this purpose.

### **Reasons for Change**

Uncertainty exists whether an employer that compensates a service provider (either an employee or an independent contractor) with stock or other property is entitled to deduct the amount that is legally required to be included in the service provider's income, or only the amount that the service provider actually includes in income. These amounts can differ, for example, if the service provider values the property incorrectly or includes it in the wrong year on their Form 1040, U.S Individual Income Tax Return.

In *Robinson v. United States*, 335 F.3d. 1365 (Fed. Cir.), *cert. denied*, 540 U.S. 1105 (2003), the Court of Appeals for the Federal Circuit held that an employer is entitled to deduct the amount "legally required to be included" in a service provider's gross income as a result of a compensatory transfer of stock, without regard to whether the employer ever reported such income on the applicable annual information return or whether the service provider ever reported the income on Form 1040. The court reasoned that the section 83(h) statutory language that allows a deduction for the amount "included" in gross income means the amount allowed as a deduction is the amount "included as a matter of law" in gross income. The *Robinson* decision considered the IRS's regulatory guidance contrary to the statute and declined to follow it.

Requiring consistency in the deduction for property transferred by a service recipient and the income inclusion for the same property by the service provider will improve compliance and ensure fair application of the tax law.

### **Proposal**

The proposal would amend section 83(h) to limit the service recipient's deduction for income attributable to property transferred in connection with the performance of services to the amount actually included in income by the service provider, and to deem the amount reported on the appropriate annual information return to be included in income for this purpose.

The proposal would be effective after December 31, 2024.

## **REFORM EXCISE TAXES ON BUSINESS AVIATION**

### **Current Law**

Under current law, the tax rate on kerosene jet fuel used by private and corporate jets (a segment known as noncommercial business aviation) is 21.8 cents per gallon. The tax is collected on behalf of and transferred to the Airport and Airway Trust Fund (AATF) to support Federal Aviation Administration (FAA) activity.

Certain noncommercial aviation operations are exempt from Federal excise tax on jet fuel. Examples of exempted operations include activity related to foreign trade, farming, nonprofit educational organization, and State and military activity.

### **Reasons for Change**

Each sector of the aviation industry should contribute revenues proportional to its use. This ensures the FAA can sustainably and equitably support existing users, ensure high-demand air space is safely allocated, and meet the growing demand for air traffic control and related services. Currently, business aviation activity does not contribute sufficient revenues to cover their costs.

Business aviation accounts for approximately three percent of the FAA's costs while contributing less than one percent to AATF revenue. As a result, private jet users are not paying taxes commensurate to the costs they impose on the FAA. Increasing existing taxes on kerosene jet fuel would align the contribution of business aviation to the costs they impose on the FAA.

### **Proposal**

The proposal would raise taxes on kerosene used for private jet travel, including corporate jets, from the current 21.8 cents per gallon to \$1.06 per gallon. The increase would be phased in over a 5-year period. In the first year, the jet fuel tax would increase from 21.8 cents per gallon to 38.64 cents with a 16.84 cent per gallon increase in each subsequent year until 2029.

This proposed excise tax increase would not affect the existing exemptions for certain noncommercial aviation operations, including foreign trade uses, farming uses, nonprofit educational uses, exclusive use by State or local government and military use. Such uses would remain exempt.

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

## **IMPROVE TAX ADMINISTRATION**

### **ENHANCE ACCURACY OF TAX INFORMATION**

#### **Current Law**

##### **Electronic filing of forms and returns**

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

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

##### **Reportable payments subject to backup withholding**

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

#### **Reasons for Change**

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

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

assessment process and allow for more efficient tax administration, particularly with respect to large or complex business entities and certain types of transactions that may warrant greater scrutiny.

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

## **Proposal**

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

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

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

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

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

Improve information reporting for reportable payments subject to backup withholding

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

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

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

### **Current Law**

Section 6226 of the Internal Revenue Code (Code) requires reviewed year partners to include in their reporting year taxes an amount equal to the change in tax that would have occurred for the reviewed year (the taxable year under audit) and all years between the reviewed year and the reporting year if the partnership adjustments were taken into account by the partners in those taxable years. The statutory formula provides, however, that for each of those years, the partners take into account the changes in tax liability that would have occurred in those years by increasing or decreasing their tax liability on their reporting year return by the sum of those changes in tax. If the calculation results in a net decrease, current law treats that net decrease as an amount that can be used by the partners to reduce their reporting year income tax liabilities to zero. Any excess of that amount not offset with an income tax due in the reporting year at the partner level does not result in an overpayment under section 6401 of the Code that can be refunded. The excess amount cannot be carried forward and is permanently lost.

### **Reasons for Change**

The inability for reviewed year partners to receive the full benefit of any reductions in tax as a result of partnership adjustments can lead to situations where a partner may be viewed as being taxed more for an adjustment made under the centralized partnership audit regime than the partner would have outside of the centralized partnership audit regime.

### **Proposal**

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

The proposal would be effective on the date of enactment.

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

### **Current Law**

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

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

### **Reasons for Change**

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

### **Proposal**

The proposal would amend the definition of a BBA Partnership-Related-Item to include items that affect a person's Chapter 2/2A taxes and would apply the sum of the highest rates of tax in section 1401(b)(1) and (b)(2) of the Internal Revenue Code in effect for the reviewed year to these items.

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

## **ALLOW PARTNERSHIPS TO RESOLVE AUDITS EARLIER**

### **Current Law**

The centralized partnership audit regime, as enacted by the Bipartisan Budget Act of 2015 (BBA), currently requires the issuance of a Notice of Proposed Partnership Adjustments (NOPPA) and a Notice of Final Partnership Adjustments (FPA) before a partnership may make an election to push out the adjustments to its reviewed year partners. By default, a partnership is liable to pay an Imputed Underpayment (IU) on partnership adjustments. A push out election transfers responsibility to pay taxes on the adjustments to its partners and relieves the partnership of its obligation to pay the IU. The partnership may pay the IU or elect to push out the adjustments at the conclusion of an audit. Partnerships have 45 days from the issuance of the FPA to elect to push out the adjustments.

### **Reasons for Change**

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

### **Proposal**

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

The proposal would be effective upon enactment.

## **MODIFY REQUISITE SUPERVISORY APPROVAL OF PENALTY INCLUDED IN NOTICE**

### **Current Law**

Section 6751(b)(1) of the Internal Revenue Code (Code) provides that no penalty under Title 26 shall be assessed unless the initial determination of such assessment is personally approved in writing by the immediate supervisor of the individual making such determination or such higher-level official as the Secretary or her delegate may designate. This section applies to all civil penalties imposed by the Code, except for penalties under section 6651 for failure to file tax returns or to pay tax; section 6654 for failure by individuals to pay estimated income tax; section 6655 for failure by corporations to pay estimated income tax; section 6662 with respect to an overstatement of certain qualified charitable contributions; and penalties that are automatically calculated through electronic means. With respect to individuals, the Internal Revenue Service (IRS) has the burden of production in a U.S. Tax Court proceeding challenging penalties to show the penalties are appropriate.

### **Reasons for Change**

Recent court decisions have led to uncertainty concerning, among other things, the requisite timing of the approval and qualified approvers. Judicial opinions have required supervisory approval of a penalty before the penalty is communicated to a taxpayer when a taxpayer still has the opportunity to raise defenses to the penalty. As a result, a supervisor may not have all the information relevant to deciding whether a penalty is appropriate by the deadline certain opinions have imposed. Many judicial opinions have barred penalties that a supervisor approved before assessment and before any opportunity for judicial review. When supervisory approval did not meet judicially-created deadlines, courts have barred penalties without considering whether the penalties were appropriate under the facts of the particular case. These barred penalties have included accuracy-related penalties where the taxpayers did not show they acted with reasonable case for underpayments on their returns. Barred penalties have also included those arising from understatements attributable to reportable transactions that the IRS identified as tax avoidance transactions or that taxpayers entered into with a significant purpose of income tax avoidance or evasion. In some cases, barred penalties have even included civil fraud penalties where the IRS has met its burden of showing by clear and convincing evidence that an underpayment of tax was attributable to fraud. These cases undercut the purpose of penalties to deter taxpayer non-compliance with tax laws, based on unclear, hard to apply rules that often apply retroactively.

### **Proposal**

The proposal would clarify that a penalty can be approved at any time prior to the issuance of a notice from which the Tax Court can review the proposed penalty and, if the taxpayer petitions the court, the IRS may raise a penalty in the court if there is supervisory approval before doing so. For any penalty not subject to Tax Court review prior to assessment, under the proposal supervisory approval could occur at any time before assessment. In addition, the proposal would expand approval authority from an “immediate supervisor” to any supervisory official, including

those that are at higher levels in the management chain or others responsible for review of a potential penalty. Finally, the proposal would eliminate the written approval requirement under section 6662 for underpayments of tax; section 6662A for understatements with respect to reportable transactions; and section 6663 for fraud penalties.

The proposal would be effective upon enactment.

## **MODIFY THE REQUIREMENT THAT GENERAL COUNSEL REVIEW CERTAIN OFFERS IN COMPROMISE**

### **Current Law**

Section 7122 of the Internal Revenue Code authorizes the Secretary to enter into an agreement with a taxpayer that settles the taxpayer's tax liabilities for less than the full amount owed if the taxpayer's case has not been referred to the Department of Justice. Such an agreement is known as an offer in compromise. The Internal Revenue Service (IRS) is authorized to compromise a liability on grounds of doubt as to liability, doubt as to collectability, or the promotion of effective tax administration.

Section 7122(b) requires the General Counsel of the Department of the Treasury, or their delegate, to review and provide an opinion in support of offers in compromise where the unpaid amount of tax assessed (including any interest, additional amount, addition to tax, and assessable penalty) is \$50,000 or more. The General Counsel has delegated legal review of offers in compromise to the Chief Counsel of the IRS, who has delegated that authority to the Small Business/Self-Employed Division (Counsel).

### **Reasons for Change**

The IRS receives thousands of offers in compromise applications every year and must verify that the requirements for compromise are met prior to proposing acceptance. Counsel reviews offers in compromise to determine whether the offers meet the legal standards of doubts of liability, doubts as to collectability, or the promotion of effective tax administration, and to ensure offers conform to the IRS's policies and procedures. The time Counsel spend on reviewing offers already reviewed by other IRS employees may delay acceptance, which may result in financial uncertainty or harm to taxpayers, while providing no additional protection of taxpayer rights.

### **Proposal**

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

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

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

### **Current Law**

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

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

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

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

### **Reasons for Change**

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

For example, a U.S. citizen working abroad who receives a salary denominated in euros every two weeks must translate each deposit into U.S. dollars at the spot rate on the date each payment is received. Consequently, the U.S. citizen must use 26 different spot rates to calculate annual compensation income to file the citizen's U.S. tax return.

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

## **Proposal**

The proposal would allow individuals living and working abroad to use an average rate for the year to calculate qualified compensation received in foreign currency, as well as for other items of income or expense of such individuals (including retired individuals) as specified in regulations. It is anticipated that the average rate generally would be available for ordinary course payments expected to recur regularly during the course of a year.

The proposal would increase the personal exemption amount for foreign currency gain from \$200 to \$600, to reflect inflation since 1986, and would index this threshold to inflation on an annual basis.

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

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

## **MODERNIZE REPORTING WITH RESPECT TO FOREIGN TAX CREDITS TO REDUCE BURDEN AND INCREASE COMPLIANCE**

### **Current Law**

Taxpayers are required to substantiate their foreign tax credits (FTC) and to notify the Secretary if certain events occur after the payment or accrual of a foreign income tax that affects the amount of such foreign income tax (a foreign tax redetermination or FTR).

While a failure to substantiate the FTC may cause the entire credit to be disallowed, there is no specific penalty or extension to the statute of limitations (SOL) for failing to provide or substantiate the information required on the FTC reporting forms (i.e., Form 1116, Foreign Tax Credit, and Form 1118, Foreign Tax Credit – Corporations). In the event of an FTR, the foreign income tax originally reported must be adjusted (along with related tax items) to redetermine the amount of U.S. tax due. If the FTR results in additional tax, the taxpayer must file an amended return and pay the additional tax due. If the taxpayer does not file an amended return, the Secretary will assess the additional tax, which is due upon notice and demand. The penalty for failure to timely report an FTR is five percent of any deficiency arising from the failure to report, increasing by five percent for each month during which the failure continues, up to 25 percent.

Current law provides an exception to certain FTC rules and reporting requirements for U.S. individuals who incur \$300 (\$600 if married and filing a joint return) or less of creditable foreign income taxes on passive investment income.

### **Reasons for Change**

Modernizing reporting requirements with respect to foreign tax credits will reduce taxpayer burden, reduce administrative costs for the IRS, and improve compliance.

Since the 1918 Revenue Act, when the FTC and FTR provisions were first enacted, the frequency, scope, and complexity of cross-border activities have substantially increased. While other tax statutes governing cross-border activities have changed substantially in response to these developments, there has been little change to the law related to FTRs and information reporting and substantiation of FTCs.

In recent years, FTRs have become burdensome for the government and taxpayers. A U.S. multinational may have hundreds of FTRs each year. The required amended returns for each affected year impose costs on taxpayers and are administratively difficult for the government. Similarly, while the requirement that additional tax be collected on notice and demand promoted compliance and efficient enforcement when FTRs were uncommon, in recent years, the audit and the assessment of tax outside of the ordinary audit work stream have proven inefficient.

The rules governing information reporting and substantiation of FTCs have likewise fallen behind international information reporting norms. While the relevant information reporting has been expanded in recent years, the lack of comprehensive rules requiring taxpayers to timely provide complete and accurate information for purposes of computing FTCs has led to

difficulties in audit and enforcement. Additionally, the penalty for failure to report an FTR is narrow and has generally been ineffective at improving compliance or promoting audit efficiency.

Finally, increasing the \$300 (\$600 in the case of a joint return) threshold for U.S. individuals would simplify return preparation for a greater number of individual taxpayers.

### **Proposal**

The proposal would expand the regulatory authority under which the Secretary may require taxpayers to furnish information relating to the verification and computation of the FTC.

The proposal would clarify that FTRs include changes in the liability for foreign income taxes as well as certain other changes that may affect a taxpayer's U.S. tax liability (e.g., a change to foreign taxes that affects the subpart F or GILTI inclusion amounts). The proposal would clarify that the Secretary will provide the form and manner of notification and would have the authority for alternative adjustments to account for FTRs, including special rules for FTRs involving taxpayers that do not claim a FTC but report foreign income taxes to their owners, such as partnerships, trusts, or certain regulated investment companies. The proposal would provide that the Secretary may provide for the assessment and collection of any U.S. tax liability resulting from an FTR in the year of the FTR and under deficiency procedures.<sup>55</sup> The Secretary may also provide alternative adjustments including appropriate netting or offsetting of adjustments, overpayments, underpayments, and interest in different years with respect to FTRs reportable in the same taxable year.

The proposal would extend the statute of limitations in the event taxpayers fail to report the required information relating to FTCs and FTRs to three years after the date on which the Secretary receives the required information. Failure to report an FTR would be subject to a penalty equal to the greater of five percent or \$10,000 for each failure, with an increase from five percent to 20 percent for willful failures. Additionally, failure to respond to any IRS information requests relating to substantiation of an FTC or FTR would be subject to a penalty equal to the greater of five percent or \$10,000 after 90 days of failing to respond, increased by the greater of five percent or \$10,000 for each subsequent 30-day period up to a maximum of the greater of 25 percent (40 percent in the case of willful failures) or \$50,000.

Finally, the proposal would increase the threshold for the exception to certain FTC rules and reporting requirements for U.S. individuals to \$600 (\$1,200 in the case of a joint return) and would index this threshold to inflation.

The increase in the threshold for the exception to certain FTC rules and reporting requirements would be effective for foreign income taxes paid or accrued in taxable years beginning after

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<sup>55</sup> This would reduce the need for taxpayers to file amended returns, allowing the adjustment to be reported on their tax return for the year of the FTR. The Secretary could provide that these amounts are assessed and collected under deficiency procedures if doing so is more efficient than issuing separate notice and demand. However, the calculation of the tax would still be calculated by reference to the relation-back year.

December 31, 2024. All other changes provided in the proposal would apply to taxable years beginning after the date of enactment, including with respect to FTRs occurring in such years that relate to prior years.

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

### **Current Law**

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

### **Reasons for Change**

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

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

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

### **Proposal**

The proposal would give officers and employees of BEA access to FTI of those sole proprietorships with receipts greater than \$250,000 and of all partnerships. No BEA contractor would have access to FTI.

The proposal would also give BLS officers and employees access to certain business (and tax-exempt entities) FTI including: Taxpayer Identification Number (TIN); name(s) of the business; business address (mailing address and physical location); principal industrial activity code (including the business description); form number and name of business tax forms filed; number of employees and total wages (including wages, tips, and other compensation), quarterly from Form 941, Employer's Quarterly Federal Tax Return, and annually from Form 943, Employer's Annual Federal Return for Agricultural Employees, and Form 944, Employer's Annual Federal Tax Return; employment code from the Business Master File; type of entity code from Form SS-4; gross receipts or sales less returns and allowances for for-profit businesses; and total revenues for non-profit organizations. The proposal would permit BLS, BEA, and the Census Bureau to share such FTI amongst themselves (subject to the restrictions described below). BLS

would not have access to individual employee FTI. No BLS contractor would have access to FTI.

The proposal would require any FTI to which BEA and BLS would have access, either directly from IRS, from the Census Bureau, or from each other, to be used for statistical purposes consistently with the Confidential Information Protection and Statistical Efficiency Act of 2002 (CIPSEA). The three statistical agencies would be subject to taxpayer privacy law, safeguards, and penalties. They would also be subject to CIPSEA confidentiality safeguard procedures, requirements, and penalties. Conforming amendments to applicable statutes would be made as necessary to apply the taxpayer privacy law, including safeguards and penalties to BLS as well as the Census Bureau and BEA.

The proposal would be effective on the date of enactment.

## **EXPAND TIN MATCHING AND IMPROVE CHILD SUPPORT ENFORCEMENT**

### **Current Law**

Section 6103(a) of the Internal Revenue Code (Code) prohibits the disclosure of returns and return information unless a provision of Title 26 provides otherwise. Section 6103 contains several provisions authorizing the disclosure of specific return information in specific circumstances. Recipients of returns or return information may not further disclose this information unless specifically authorized by law and must maintain returns and return information according to strict procedures to safeguard such data. Information security requirements for Federal, state, and local agencies receiving taxpayer information are described in *IRS Publication 1075, Tax Information Security Guidelines*.<sup>56</sup>

The Internal Revenue Service (IRS) has established a Taxpayer Identification Number (TIN) Matching Program for payors of certain reportable payments subject to the backup withholding provisions of section 3406 of the Code. The TIN Matching Program allows taxpayers required to file certain information returns to confirm that the TIN-name pairs for which the taxpayer intends to file a return match IRS records. No information other than a numerical indicator for the validity of the match is disclosed.

Separately, section 6103 authorizes the IRS to disclose certain return information to Federal, State, and local child support enforcement agencies (CSEs). Section 6103 further authorizes CSEs to disclose some, but not all, of that information to their contractors. Such redisclosures are authorized solely for the purposes of establishing or collecting child support obligations and locating individuals owing child support obligations. There is no explicit authority in section 6103 for the IRS to disclose to Tribal CSEs or their contractors return information for purposes of child support enforcement.

The Federal tax refund offset program collects past-due child support payments from the tax refunds of parents who owe support, but the program only covers past-due child support from a court order or an administrative process established under State law.

### **Reasons for Change**

Because the TIN Matching Program only applies to reportable payments under section 3406, the Program does not apply to a number of widely-used information returns, including Form 1098, Mortgage Interest Statement; Form 1098-T, Tuition Statement; Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.; Form 5498, IRA Contribution Information; Form 1099-G, Certain Government Payments; Form 1099-S, Proceeds from Real Estate Transactions; and Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding. Expanding IRS authority to apply the TIN Matching Program to all information return filers would save the government and taxpayers significant resources and would result in fewer reporting errors, IRS notices, and penalties.

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<sup>56</sup> IRS Publication 1075, *Tax Information Security Guidelines for Federal, State and Local Agencies: Safeguards for Protecting Federal Tax Return and Return Information*, revised November, 2021. <https://www.irs.gov/pub/irs-pdf/p1075.pdf>

State and local CSEs rely on their contractors for efficient child support operations. Expanding the ability of CSEs to share information with their contractors will facilitate the establishment and collection of child support obligations, the locating of individuals owing child support obligations, and the administration of the Federal tax refund offset program.

Because Tribal CSEs are not explicitly identified in section 6103, they are not able to use return information to establish or collect child support or locate individuals with child support obligations in the same way that State and local CSEs are even though they perform similar functions. In addition, because they are not listed in section 6402 of the Code Tribal CSEs are not able to use the Federal tax refund offset program to collect past-due support.

### **Proposal**

The proposal would amend section 6103 to permit TIN matching for filers of all information returns requiring the reporting of names and TINs.

The proposal would also amend section 6103(l) to allow CSEs to share all of the information they receive with their contractors, subject to the same confidentiality and safeguard provisions applicable to recipients of return information under current law. It would also provide Tribal CSEs with the same access to the same return information as Federal, State, and local CSEs, and would amend section 6402(c) to provide Tribal CSEs with access to the Federal tax refund offset program.

These proposals would be effective upon enactment.

## **CLARIFY THAT INFORMATION PREVIOUSLY DISCLOSED IN A JUDICIAL OR ADMINISTRATIVE PROCEEDING IS NOT RETURN INFORMATION**

### **Current Law**

Section 6103(a) of the Internal Revenue Code (Code) prohibits the disclosure of returns and return information unless a provision of Title 26 provides otherwise. Section 6103 contains several provisions authorizing the disclosure of specific return information in specific circumstances.

While section 6103(h) permits certain disclosures of returns and return information in judicial and administrative tax proceedings, neither this exception nor any other section 6103 exception explicitly creates a general authorization to redisclose return information that has previously been disclosed during a judicial or administrative proceeding and become public information as a result.

### **Reasons for Change**

In abusive tax transaction cases where the Internal Revenue Service refers the case to the Department of Justice (DOJ), it is common for DOJ to issue a press release as a key tool to encourage taxpayer compliance. For example, by announcing the filing of a complaint in abusive tax transactions cases, the government alerts taxpayers that certain transactions and conduct will draw the attention of the government and that the government will seek to enjoin those transactions and conduct. Taxpayers not monitoring court filings may become aware of abusive tax schemes to watch out for through the government's press releases designed to reach broader audiences. Disclosures for purposes of judicial and administrative proceedings are explicitly authorized under section 6103 but press releases or other communications relating to this previously disclosed information that has been made part of the public record are not explicitly referenced in section 6103.

### **Proposal**

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

The proposal would be effective upon enactment.

## **REQUIRE EARLIER ELECTRONIC FILING DEADLINES FOR CERTAIN INFORMATION RETURNS**

### **Current Law**

Most electronically filed information returns, including those reporting gambling winnings, unemployment compensation, social security benefits, interest income, dividend income, distributions from retirement plans, cancellation of indebtedness, and mortgage interest are required by statute to be filed with the Internal Revenue Service (IRS) by March 31 of the year following the year for which the information is being reported. Electronically filed returns and statements relating to employee wage information and nonemployee compensation are subject to an earlier filing deadline of January 31 of the year following the calendar year to which such returns relate.

Third parties filing information returns with the IRS must also furnish a copy to payees. The deadline for furnishing this information to payees is earlier than the deadline to file the return with the IRS in most cases. A copy of the information filed with the IRS for most information returns is required to be furnished to payees by January 31 of the year following the year for which the information is being reported. In the case of payments reported on the Form 1099-B, statements to payees are required to be furnished by February 15.

Individuals are generally required to file their income tax returns by April 15 of the year following the close of the calendar year, but many file earlier, before the IRS has received the relevant information returns.

### **Reasons for Change**

An earlier filing deadline for certain information returns can improve tax administration for both the government and taxpayers.

The IRS uses third-party information reporting to determine a taxpayer's compliance with Federal tax obligations. The information is also used to detect fraud and identity theft. The current March 31 deadline for most electronically filed information returns is well after the start of the filing season, limiting the IRS's real-time matching of information reporting to tax returns. Accelerating the IRS's receipt of third-party information will facilitate detection of non-compliance earlier in the filing season and will reduce identity theft and fraud.

In addition, providing the IRS with access to this information at the time when taxpayers receive the same information (for most returns January 31 or February 15) can facilitate the electronic use of data during the tax return filing season, which can simplify the tax preparation process for individuals and reduce errors, such as the inadvertent omission of income or expense information already furnished to the individual. Accelerating the IRS's receipt of third-party information will also support the implementation of the *IRS Inflation Reduction Act Strategic Operating Plan*<sup>57</sup>

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<sup>57</sup> IRS Publication 3744: *Internal Revenue Service Inflation Reduction Act Strategic Operating Plan FY2023-FY2031*, April 2023. <https://www.irs.gov/pub/irs-pdf/p3744.pdf>

including the delivery of proactive alerts and helping taxpayers start their returns with data that can go directly into return preparation software.

**Proposal**

The proposal would amend Section 6071(b) to require information returns made under sections 6041 through 6050Z of the Code (other than returns and statements required to be filed with respect to nonemployee compensation) to be filed on or before the date returns are required to be furnished to payees and other recipients.

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

## **ALLOW THE TAX COURT TO REVIEW ALL EVIDENCE IN INNOCENT SPOUSE RELIEF CASES**

### **Current Law**

A married taxpayer who files a joint return is jointly and severally liable for any tax liability stemming from that return. However, a taxpayer may be eligible for innocent spouse relief and relieved from all or a portion of any tax liability that evolved from the actions of their spouse. For example, if their spouse understated the tax due on their joint return without the taxpayer's knowledge, innocent spouse relief can reduce or completely remove the tax liability from the "innocent" spouse. When determining whether to grant relief, the Internal Revenue Service (IRS) considers several factors, such as knowledge, financial hardship, and whether the spouse requesting relief separated or got divorced from the taxpayer who misreported the taxpayer's income or underpaid taxes. To initiate a request for relief, a taxpayer is required to complete a form and submit documentation that ultimately becomes part of the IRS's administrative record.

Taxpayers may petition the Tax Court to review adverse determinations by the IRS involving innocent spouse relief. As part of the Taxpayer First Act of 2019, Congress amended section 6015 of the Internal Revenue Code to provide a *de novo* standard of review for innocent spouse relief determinations. A *de novo* standard allows the Tax Court to engage in a new analysis without deference to the IRS's decision. However, this legislation limited the scope of review to a) the administrative record at the time of the IRS's determination and b) any newly discovered or previously unavailable evidence. Therefore, the Court may not consider information that was previously available but is not in the administrative record.

### **Reasons for Change**

The statutory limitation on the scope of review in innocent spouse relief cases prevents the Tax Court from fully reviewing cases for taxpayers who did not present a complete administrative record or submit critical documentation to the IRS prior to the time of the final determination.

Some taxpayers may overlook or not submit evidence that would have helped their case, or they may be reluctant to share certain information with the IRS that they may be more comfortable sharing with a judge. Additionally, some administrative records, which include the facts and circumstances of each case, may not be fully developed, and the taxpayer may have little control over the maintenance and completeness of the agency's administrative case file. Consequently, the outcome of the taxpayer's case before the Tax Court may significantly depend on the IRS's factual development and analysis of the case, and whether it was accurate and complete.

Expanding the scope of Tax Court review will reduce the risk that taxpayers bear tax liability due to the lack of a complete and accurate administrative record. Eliminating the existing limitations on the scope of Tax Court review will enhance due process in innocent spouse cases and lead to more equitable outcomes for taxpayers petitioning the Tax Court for review.

**Proposal**

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

The proposal would be effective on the date of enactment.

## **PERMIT ELECTRONICALLY PROVIDED NOTICES**

### **Current Law**

The Internal Revenue Service (IRS) sends notices by mail to taxpayers for a variety of reasons. A notice may inform taxpayers about a change to their accounts, an issue on their tax returns, a request for information or a payment, or other information. It may also provide taxpayers with the information about important deadlines and their statutory rights. Various provisions in the Internal Revenue Code (Code) specify that a notice must be sent by certified or registered mail to the taxpayer's last known address. Some of these notices grant taxpayers the right to contest the IRS's proposed administrative actions, including those that would take place in the Independent Office of Appeals or in a Federal court of law.

### **Reasons for Change**

The notice requirements protect taxpayers because if the IRS does not adhere to the requirements provided by statute, it may be limited in its ability to pursue administrative actions. For example, pursuant to section 6303 of the Code, if the IRS fails to mail to a taxpayer's last known address a notice and demand for payment of tax within 60 days of assessment, then the IRS may be prohibited from using administrative means for collection. In this case, the IRS may lose priority over other creditors for repayment in certain situations (for example, in bankruptcy proceedings) and be required to bring suit to collect.

A taxpayer may also be disadvantaged by the requirement that the IRS notify taxpayers of their rights by certified or registered mail to the taxpayers' last known address. For example, pursuant to section 6212 of the Code, the IRS must send its notice of a proposed increase in tax liability to the taxpayer by "certified or registered mail" to the taxpayer's "last known address." This notice advises the taxpayer of the right to petition the U.S. Tax Court for a review of that determination. So long as the IRS complies with this requirement, the notice is legally effective when sent and the time limit begins to run on that day, regardless of whether or when the taxpayer receives the correspondence.

To modernize the agency and create a seamless taxpayer experience, the IRS is digitizing forms, creating online accounts, and allowing taxpayers to elect to correspond electronically with the IRS. Taxpayers may elect to digitally receive and submit certain correspondence with the IRS. However, even when a taxpayer elects to receive notices electronically, such notices do not satisfy the statutory requirement that certain notices must be sent by certified or registered mail to a taxpayer's last known address. Allowing taxpayers to elect to receive IRS notices by means of secure, trackable, electronic transmission in lieu of, or in addition to, paper notices can reduce administrative burdens on the IRS and taxpayers by ensuring these notices are delivered and retained through a second medium.

### **Proposal**

The proposal would amend all Code provisions which require notice by mail (including notice by certified or registered mail sent to the taxpayer's last known address) such that electronic notice

pursuant to the taxpayer's election or preference will have the same legal effect as a mailed notice. The IRS would still be obligated to send these notices by mail unless the taxpayer elected to receive such notices only electronically.

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

## REFORM FEDERAL GRANTS TO LOW-INCOME TAXPAYER CLINICS

### **Current Law**

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

Section 7526 authorizes the Secretary, subject to the availability of appropriated funds, to provide grants of no more than \$100,000 per clinic per year. The Secretary may award multi-year grants, not to exceed three years. The grant limitation in section 7526 is not indexed for inflation and has remained at \$100,000 since the program's creation in 1998. However, the Consolidated Appropriations Act, 2023 provided for grants to individual clinics of up to \$200,000. Further, section 7526 requires LITCs to match the grant funds on a dollar-for-dollar basis (a 100 percent matching funds requirement).

### **Reasons for Change**

The LITC program plays a valuable role in strengthening tax administration by ensuring low-income and ESL taxpayers have access to representation in tax disputes, by providing outreach, and through systemic advocacy. In 2022, LITCs represented almost 20,000 taxpayers and educated almost 57,000 taxpayers and service providers.<sup>58</sup>

The statutory cap of \$100,000 per clinic on grant funding limits the expansion of the LITC program and its overall impact on low-income and ESL taxpayers. At this level, well-functioning clinics struggle to expand and maximize their impact in their communities. Additionally, the 100% matching requirement presents challenges to the expansion of existing clinics and the launch of new clinics in underserved areas where it is difficult to raise funds from other sources. For example, potential clinics are sometimes unable to open due to an inability to match funds and to receive a grant award that is sufficient to cover operating expenses.

The LITC Program Office could ensure more taxpayers receive LITC services if it had authority to provide larger grants to clinics that use the grant funds especially effectively, consistent with the objective of providing maximum geographic coverage to taxpayers across the United States. Additionally, the LITC Program Office could use discretion to reduce the matching requirement to provide more support to clinics in underserved areas.

### **Proposal**

The proposal would increase the annual limitation on grants to a single clinic to \$200,000, indexed for inflation. In addition, while the applicable percentage of matching funds generally

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<sup>58</sup>IRS Publication 5066, *Low Income Taxpayer Clinics 2023 Program Report*, <https://www.irs.gov/pub/irs-pdf/p5066.pdf>, December 2023. Forms 13424-A and 13424-K, Low Income Taxpayer Clinic (LITC) General Information Report; data compiled by GrantSolutions.

would remain at 100%, the Secretary would be granted authority to reduce the matching requirement to as low as 25%, where doing so would serve the mission of the LITC program. For example, the Secretary could reduce the match to 25% for clinics in areas that are underserved or that require additional monetary support to launch or operate the clinic.

The proposal would be effective upon enactment.

## **IMPROVE TAX COMPLIANCE**

### **ADDRESS TAXPAYER NONCOMPLIANCE WITH LISTED TRANSACTIONS**

#### **Current Law**

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

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

In a typical case, an intermediary entity borrows funds to purchase the stock of the C corporation from the C corporation's shareholders, and the consideration received by the C corporation from the sale of its assets is effectively used to repay that loan. These transactions are structured so that when a C corporation's assets are sold, the C corporation is ultimately left with insufficient assets from which to pay the tax owed from the asset sale. In many cases, the intermediary does not pay the corporate income tax liability and is judgment-proof, frustrating the IRS's ability to collect taxes that are legally owed.

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

#### **Reasons for Change**

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

the IRS can proceed to collect the unpaid taxes. The selling shareholders are typically the only parties with sufficient assets in the United States against which the IRS could proceed for collection; however, it has proven difficult for the IRS to effectively collect the unpaid Federal taxes from these selling shareholders under current law. Even though the IRS has pursued litigation to enforce collection from the selling shareholders of several corporations, these actions have yielded mixed results in factually similar cases. Thus, existing law does not adequately protect the Federal Government's interest in collecting the amounts due from selling shareholders as a result of these transactions.

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

## **Proposal**

### **Extend statute of limitations for listed transactions**

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

This proposed change would be effective on the date of enactment.

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

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

For purposes of the proposal, an applicable C corporation is any C corporation (or successor) two thirds or more of whose assets consist of cash, passive investment assets, or assets that are the subject of a contract of sale or whose sale has been substantially negotiated on the date that a controlling interest in its stock is sold. The proposal would grant the Secretary authority to prescribe regulations necessary or appropriate to carry out the proposal.

The proposal would not apply with respect to dispositions of a controlling interest (a) in the stock of a C corporation or real estate investment trust with shares traded on an established securities

market in the United States, (b) in the shares of a regulated investment company that offers shares to the public, or (c) to an acquirer whose stock or securities are publicly traded on an established securities market in the United States, or is consolidated for financial reporting purposes with such a public issuer of stock or securities.

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

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

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

### **Current Law**

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

The accuracy-related penalty is subject to a reasonable cause and good faith exception. This exception applies on a case-by-case basis and requires consideration of all relevant facts and circumstances, including whether the taxpayer reasonably relied in good faith on the opinion or advice of a professional tax advisor. However, a taxpayer cannot rely on a tax advisor's opinion that a regulation is invalid to establish reasonable cause and good faith if the taxpayer did not adequately disclose the position.

### **Reasons for Change**

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

In recent years, a growing number of taxpayers – especially large multinational entities – have taken tax positions on their returns that are contrary to a regulation. Such positions are difficult for the IRS to identify if the taxpayer chooses not to disclose them for penalty protection purposes. Some taxpayers have eschewed penalty protection by forgoing the disclosure of positions that are contrary to a regulation in the hopes of avoiding scrutiny.

### **Proposal**

The proposal would impose an affirmative requirement on taxpayers to disclose a position on a return that is contrary to a regulation. Except to the extent provided in regulations for failures due to reasonable cause and not willful neglect, a taxpayer who fails to make the required disclosure would be subject to an assessable penalty that is 75 percent of the decrease in tax shown on the return as a result of the position. Such penalty shall not be less than \$10,000 or more than \$200,000, adjusted for inflation. The penalty would not apply if a taxpayer reasonably and in good faith believed that its position is consistent with the regulation. The penalty would apply regardless of whether the taxpayer's interpretation of the regulation is ultimately upheld.

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

## **REQUIRE EMPLOYERS TO WITHHOLD TAX ON FAILED NONQUALIFIED DEFERRED COMPENSATION PLANS**

### **Current Law**

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

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

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

### **Reasons for Change**

Internal Revenue Service (IRS) employment tax examiners can assess the regular Federal income tax withholding on an employer through an employment tax examination of the employer. However, IRS examiners are unable to collect from employers the 20 percent additional tax or additional interest tax on NQDC that fails to comply with the section 409A tax requirements. Instead, in the case of NQDC that fails to satisfy the tax requirements, the IRS examiner must assess the employee for the 20 percent additional tax and the additional interest tax. Initiating exams of each employee for these additional taxes is time-consuming, administratively impractical, burdensome, and an inefficient use of IRS resources.

### **Proposal**

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

The proposal would be effective after December 31, 2024.

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

### **Current Law**

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

### **Reasons for Change**

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

### **Proposal**

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

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

## **INCREASE THE STATUTE OF LIMITATIONS ON ASSESSMENT OF THE COVID-RELATED PAID LEAVE AND EMPLOYEE RETENTION TAX CREDITS**

### **Current Law**

The Families First Coronavirus Response Act of 2020 (FFCRA) enacted the paid sick and family leave tax credit (the paid leave tax credit) entitling certain employers to a refundable tax credit for the payment of qualified leave wages. The Coronavirus Aid, Relief, and Economic Security Act of 2020 (CARES Act) enacted the employee retention tax credit (ERC) entitling certain employers to a refundable tax credit for the payment of qualified wages. The paid leave tax credit under the FFCRA and the ERC under the CARES Act applied to wages paid during the second, third, or fourth quarters of 2020. Subsequent legislation – the COVID-Related Tax Relief Act of 2020 (Relief Act) and American Rescue Plan Act of 2021 (ARP) – extended the paid leave tax credit for qualified leave wages paid during the first, second or third quarters of 2021 and extended the ERC for qualified wages paid during the first, second, third or fourth quarters of 2021. ARP also codified the paid leave credit and ERC provisions in the Internal Revenue Code (Code). (The Infrastructure Investment and Jobs Act of 2021 amended the ERC to apply only to wages paid prior to October 1, 2021, except for employers in limited circumstances.)

These credits were claimed on employment tax returns, which generally are filed quarterly on Form 941, Employer’s Quarterly Federal Tax Return (with a small number of employers, including household employers, filing annually on other forms). The due date for a quarterly Form 941 filing generally is the last day of the month following the quarter to which it applies – e.g., the due date for Form 941 in the first quarter of 2021 was April 30, 2021. The Relief Act expanded ERC eligibility and applied retroactively to quarters with filing due dates that already had passed. To claim the ERC for a prior quarter, an employer is required to file an amended employment tax return, generally on Form 941-X, Adjusted Employer’s Quarterly Federal Tax Return or Claim for Refund, for each earlier quarter.

In general, taxpayers must file a claim for credit or refund within the later of three years from the time the tax return was filed or two years from the time the tax was paid. For this purpose, if an employment tax return for a period ending with or within a given calendar year is filed on or before April 15 of the succeeding calendar year, the return is considered filed on April 15 of that succeeding calendar year. For example, all timely filed Forms 941 for any quarter of 2020 are considered filed on April 15, 2021. Thus, an employer that timely filed and paid employment tax may file a claim for ERC with respect to any quarter of 2020 by filing an amended employment tax return, generally Form 941-X, until April 15, 2024. For all timely-filed Forms 941 for any quarter of 2021, the same deadlines apply as in the previous sentence, but one year later.

Taxpayers that claim either the paid leave tax credit or the ERC must reduce their income tax deduction for wages paid by the amount of those credits. Accordingly, when taxpayers claim the ERC or paid leave tax credit on an amended employment tax return, they must also amend their income tax return for the year in which the wages were paid no later than three years from the time the income tax return was filed or two years from the time the income tax was paid.

Generally, the Internal Revenue Service (IRS) must assess any additional tax within three years after a return's original filing date (whether or not the return was filed on any extension). The timing for when a return is considered "filed" for this purpose is similar to the rule as it pertains to the time for filing a claim for credit or refund on an amended return: if an employment tax return for a period ending with or within a calendar year is filed before April 15 of the succeeding calendar year, the return is considered filed, for purposes of the statute of limitations on assessment, on April 15 of that succeeding calendar year. The period of limitations on assessment generally does not restart upon the filing of an amended return.

As a result of these timing rules, it is often the case that the statutes of limitations on assessment and refund expire at the same time. For example, if an employer timely filed its employment tax returns and timely paid its employment tax, for the calendar year 2020, the employment tax returns and employment tax would be deemed filed and paid on April 15, 2021. The statute of limitations for the IRS to assess additional tax, and for the employer to claim a refund, would end on the same day: April 15, 2024, which is three years after April 15, 2021.

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

### **Reasons for Change**

Providing a consistent rule for the limitations period to assess erroneous FFCRA paid leave credits and the CARES Act ERC, as amended prior to the ARP, would assist with IRS compliance and enforcement efforts. Additionally, a significant number of ERC claims were made on amended tax returns, often with a substantial delay relative to the quarter of the underlying activity that generated the credit, and amended returns with new ERC claims continue to be filed. The current-law three-year limitations period applicable to the FFCRA paid leave credits and the ERC does not restart when an amended return is filed, making it difficult for the IRS to ensure compliance with respect to such amended returns, many of which the IRS believes have been filed incorrectly.

### **Proposal**

The proposal would extend the limitations on the time period for the assessment of erroneous paid leave tax credits under the FFCRA and the ERC under the CARES Act, as amended prior to the ARP, to conform with the same five-year period provided under ARP. Additionally, the

proposal would extend the limitations period for the IRS to assess additional income tax from the taxpayer if the taxpayer that claimed the ERC or paid leave tax credit did not make a corresponding downward adjustment to its wage deduction on Forms 1120, 1065, or 1040.<sup>59</sup>

The proposal would be effective on the date of enactment.

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<sup>59</sup> These three forms are the Federal income tax returns for corporate income, partnership income, and individual income respectively. The full titles are Form 1120, U.S. Corporation Income Tax Return; Form 1065, U.S. Return of Partnership Income; and Form 1040, U.S. Individual Income Tax Return.

## **IMPOSE PENALTIES FOR INACCURATE OR FRAUDULENT EMPLOYMENT TAX RETURNS**

### **Current Law**

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

Congress enacted several refundable credits against employment tax during the COVID-19 pandemic. For example, the employee retention credit (ERC) provides a refundable credit against employment taxes for the payment of qualified wages. Eligible employers can claim the credit on an original or amended employment tax return. Similarly, the paid leave credits for small and midsize businesses generally allow employers with fewer than 500 employees who paid COVID-related sick leave or family leave wages to claim refundable tax credits against employment taxes for qualified leave wages. Currently, there is no civil penalty applied to an erroneous claim for refund or credit of employment taxes.

### **Reasons for Change**

Currently, claims for refund or credit with respect to employment taxes are not subject to the penalty for erroneous refund claims under section 6676. Expanding the authority of the Internal Revenue Service (IRS) to assert a penalty against those taxpayers who have improperly filed for employment tax refunds will support sound tax administration and provide parity with existing penalty provisions regarding excessive refund or credit claims for income taxes.

The IRS is actively auditing and conducting criminal investigations related to false ERC claims. However, the Administration has serious concerns about improper ERC claims, including claims made by entities that did not exist or did not have employees during the period of eligibility. Extending penalties to improper claims for refunds or credits with respect to employment taxes in cases where the reasonable cause exception is not substantiated would discourage these sorts of fraudulent claims.

### **Proposal**

The proposal would extend the penalty under section 6676 to erroneous claims for refund or credit with respect to employment taxes. The proposal would be effective for claims for which the statute of limitations has not expired as of the date of enactment.

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

### **Current Law**

#### Penalties for return preparation and e-filing

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

While the Internal Revenue Code authorizes the Internal Revenue Service (IRS) to issue PTINs, it provides no authority to revoke or rescind issued PTINs. As a result, unless a paid tax return preparer is enjoined by a court from preparing returns, there is no authority to preclude a paid tax return preparer who misuses or abuses taxpayers and/or the tax system from continuing to prepare returns. Additionally, there is no authority to address paid tax return preparers who are deemed to be unsuitable to prepare returns based upon a continual failure to comply with their own tax obligations.

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

In addition, many taxpayers rely on e-file providers to electronically originate and transmit their returns to the IRS. E-file providers must apply with the IRS and pass a suitability check before becoming an authorized e-file provider and receiving an Electronic Filing Identification Number (EFIN), which is required to electronically file tax returns. There is no civil penalty on e-file provider misconduct.

#### IRS oversight of paid preparers

Under U.S. Code Title 31 (Money and Finance), Section 330 – Practice before the Department, the Secretary has the authority to regulate practice before the IRS. Regulations under that section, referred to as “Circular 230,” regulate the practice of licensed attorneys, certified public accountants, and enrolled agents and actuaries. In 2009, in response to concerns about the lack of regulation of unlicensed and unenrolled paid tax return preparers, the IRS conducted a formal review of its regulation of paid tax return preparers. After significant consideration and input

from taxpayers, tax professionals, and other stakeholders, Treasury and the IRS amended Circular 230 to regulate practice of all paid tax return preparers, including individuals who are unlicensed and unenrolled. Paid tax return preparers challenged these regulations in *Loving v. Commissioner*. The Court of Appeals for the District of Columbia Circuit determined that these regulations exceeded the IRS's authority in 2014.<sup>60</sup>

## **Reasons for Change**

### **Expand and increase penalties for return preparation and e-filing**

Inappropriate behavior by paid tax return preparers harms taxpayers through the filing of inaccurate returns, erroneous refunds and credits, and personal tax return noncompliance. It may also diminish public confidence in the tax system, which relies on the public's cooperation. In addition, the inability to immediately address issues of suitability, noncompliance, or taxpayer abuses by paid tax return preparers with valid identification numbers reflects poorly on tax administration and taxpayer confidence. Despite the penalties that may apply to paid tax return preparers, tax-return-preparer misconduct has continued, in part, because the amounts of the penalties under current law do not adequately promote voluntary compliance.

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

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

### **Grant authority to IRS for oversight of paid preparers**

Paid tax return preparers have an important role in tax administration because they assist taxpayers in complying with their obligations under the tax laws. Incompetent and dishonest paid tax return preparers increase collection costs, reduce revenues, disadvantage taxpayers, and undermine confidence in the tax system.

The current lack of authority to provide oversight on paid tax return preparers results in greater non-compliance when taxpayers who use incompetent preparers or preparers who engage in unscrupulous conduct become subject to penalties, interest, or avoidable costs of litigation due to

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<sup>60</sup> *Loving v. Commissioner*, 742 F.3d 1013 (D.C. Cir. 2014).

the poor-quality advice they receive. The lack of authority affects revenues to the IRS when the resulting noncompliance is not mitigated during return processing. Regulation of paid tax return preparers, in conjunction with diligent enforcement, will help promote high quality services from paid tax return preparers, will improve voluntary compliance, and will foster taxpayer confidence in the fairness of the tax system.

### **Proposal**

The proposal would make the following changes to current law:

#### Expand and increase penalties for return preparation and e-filing

The proposal would increase the amount of the tax penalties that apply to paid tax return preparers for willful, reckless, or unreasonable understatements, as well as for forms of noncompliance that do not involve an understatement of tax.

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

For all of the new or increased penalties in the proposal, the specified dollar amounts and any applicable annual limitations would be adjusted for inflation. The dollar penalties under current law and under the proposal are summarized in the table following the description of the proposal.

In addition, the proposal would expand the authority to determine the suitability of paid tax return preparers applying for identification numbers and the authority to revoke identification numbers for paid tax return preparers subsequently determined to be unsuitable.

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

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

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

#### Grant authority to the IRS for oversight of all paid preparers

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

The proposal would be effective on the date of enactment.

The following table shows selected penalties faced by paid preparers under current law for taxable year 2024, and under the proposal for paid preparers, e-file providers, and taxpayers for taxable year 2025.

**SUMMARY OF SELECTED PENALTIES UNDER CURRENT LAW (CALENDAR YEAR 2024) AND THE PROPOSAL (CALENDAR YEAR 2025)**

**Calculation of Penalties**

<b>NONCOMPLIANT BEHAVIOR</b>	<b>CURRENT LAW</b>		<b>PROPOSAL</b>	
<b>1. UPDATED PENALTIES FOR UNDERSTATEMENT OF LIABILITY</b>				
<b>Understatement due to ...</b>	Greater of \$X or X% of income derived by preparer with respect to return or claim			
unreasonable conduct	\$1,000 or 50%		\$5,000 or 50%	
willful or reckless conduct	\$5,000 or 75%		\$10,000 or 100%	
<b>2. UPDATED PENALTIES FOR REASONS OTHER THAN UNDERSTATEMENT OF LIABILITY</b>				
<b>Failure to ...</b>	<b>Per Offense</b>	<b>Maximum</b>	<b>Per Offense</b>	<b>Maximum</b>
furnish a copy of a return or a claim for refund to taxpayer	\$60	\$30,000	\$250	\$50,000
sign a copy of a return or a claim for refund	\$60	\$30,000	\$1,000	\$75,000
furnish preparer's identifying number	\$60	\$30,000	\$1,000	\$75,000
retain completed copy of prepared return or list of taxpayers for whom returns were prepared	\$60	\$30,000	\$250	\$50,000
file correct information returns identifying the return preparers employed by a person	\$60	\$30,000	\$250	\$50,000
refrain from endorsing or negotiating a check in respect of taxes	\$600	None	\$1,000	None
comply with certain due diligence requirements <sup>2</sup>	\$600	None	\$1,500	None
<b>3. NEW PENALTIES ON PREPARERS, E-FILE PROVIDERS, AND TAXPAYERS:</b>				
<b>NONCOMPLIANT BEHAVIOR</b>	<b>Per Offense</b>	<b>Maximum<sup>2</sup></b>	<b>Per Offense</b>	<b>Maximum<sup>2</sup></b>
<b>Appropriation of ...</b>				
a PTIN			\$1,000	\$75,000
an EFIN			\$250	None
Failure to disclose use of preparer and fees paid to preparer by taxpayer.			\$500	None

<sup>1</sup>Taxpayers and the preparers they use must comply with the requirement of IRS Form 8867, Paid Preparers' Due Diligence Checklist for the Earned Income Credit, American Opportunity Tax Credit, Child Credit (including the Additional Child Tax Credit and the Credit for Other Dependents) and/or Head of Household Filing Status.

<sup>2</sup>Maximum is annual maximum per calendar year.

## **MAKE REPEATED WILLFUL FAILURE TO FILE A TAX RETURN A FELONY FOR THOSE WITH SIGNIFICANT TAX LIABILITY**

### **Current Law**

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

### **Reasons for Change**

Voluntary tax compliance is the foundation of our tax system. Non-compliance by high-income taxpayers has a significant corrosive effect on tax administration and collection. A significant portion of the non-filer tax gap – the difference between tax liability and the taxes paid – is attributable to high-income non-filers. Closing the tax gap is critical to a fair tax system and best serving the public good, as those who do not pay their taxes shift the tax burden to those who meet their tax obligations. Increasing criminal penalties for high-income people who willfully and repeatedly do not file a tax return would provide a more effective deterrent to such blatant tax evasion, encourage voluntary compliance and help close the tax gap.

### **Proposal**

The proposal would amend section 7203 of the Internal Revenue Code to increase criminal penalties for high-income people with significant Federal tax liability who willfully fail to file a tax return for multiple years. The proposal would provide that any person who willfully fails to file timely required tax returns in any three years within a consecutive five-year period, where the aggregate tax underpayment for such five-year period is more than \$250,000, would be subject to a new aggravated failure-to-file criminal penalty. The offense would be classified as a felony, punishable by a term of imprisonment of no more than five years, a fine of up to \$250,000 (\$500,000 in the case of a corporation), or both.

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

## **EXPAND IRS SUMMONS AUTHORITY FOR LARGE PARTNERSHIPS**

### **Current Law**

The statute of limitations on assessment limits the ability of the Internal Revenue Service (IRS) to assess additional tax against a taxpayer after a certain period of time has passed, generally three years. However, for corporate taxpayers being examined under the IRS's Large Corporate Compliance program, the statute of limitations on assessment can be suspended via the issuance of a designated summons. A designated summons can only be issued under certain limited circumstances and is subject to written approval by the Chief Counsel of the IRS and select others. Designated summonses must be served at least 60 days before the statute of limitations expires. The IRS must establish in a judicial enforcement proceeding that prior reasonable requests were made to obtain the information sought from the taxpayer. The taxpayer's statute of limitations is suspended for 120 days following a court's enforcement of the summons. If a court does not enforce the summons, the statute of limitations remains suspended for 60 days following the court proceeding (including a period for appeal of the decision).

The designated summons provisions, however, do not apply to large partnerships, such as complex investment funds and hedge funds.

Partnerships examined under the IRS's large partnership compliance program (LPC) are subject to the centralized partnership audit regime, as enacted by the Bipartisan Budget Act of 2015 (BBA), where any understatement is determined at the partnership, rather than the partner, level.

### **Reasons for Change**

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

### **Proposal**

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

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

The proposal would be effective after the date of enactment.

## **ADDRESS COMPLIANCE IN CONNECTION WITH TAX RESPONSIBILITIES OF EXPATRIATES**

### **Current Law**

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

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

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

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

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

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

Generally, the Internal Revenue Service (IRS) has three years from the date a return is filed to assess the tax. However, existing law extends the assessment statute of limitations in certain

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

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

With some exceptions, an individual who is not a U.S. citizen is required to obtain a certificate from the IRS (generally referred to as a "sailing permit") that the individual has complied with all of the individual's income tax obligations before departing from the United States.

### **Reasons for Change**

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

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

that they are compliant with all U.S. Federal tax obligations for the five preceding taxable years. For taxpayers with modest incomes who have not been filing U.S. tax returns but have been filing tax returns and paying tax in their countries of residence, the cost and practical difficulties of certifying compliance with their U.S. Federal tax obligations may impede their ability to satisfy the requirements for expatriation. For example, it may be difficult to find a U.S. tax advisor to prepare a U.S. tax return in the taxpayer's country of residence, and the cost of doing so may be significant for a lower-income taxpayer. If the taxpayer would not owe any U.S. tax, the benefit to the IRS of the filing of such tax returns is limited.

The requirement for an alien to obtain a sailing permit is no longer necessary as the IRS has other tools to help ensure tax compliance, including withholding tax requirements applicable to payments to nonresident aliens that have been implemented since the sailing permit requirement was originally enacted.

### **Proposal**

First, the proposal would provide that, in the case where a taxpayer is required to provide Form 8854 to the IRS with their tax return, the time for assessment of tax will not expire until three years after the date on which Form 8854 is filed with the IRS. This would create parity with the current statute of limitation rules for tax returns when other information returns relating to various international transactions or assets are required to be filed with the return. The proposal would reduce abuse and noncompliance with respect to high net wealth expatriates.

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

The requirement for an alien to obtain a sailing permit would be repealed.

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

## **DEFINE CONTROL OF THE PAYMENT OF WAGE**

### **Current Law**

Employers are required to pay employment taxes and withhold income tax from wages paid to the employees. Section 3401(d) of the Internal Revenue Code defines an “employer” generally as the person for whom an individual performs services as the employee. Section 3401(d)(1) provides an exception if the person for whom the individual performs services does not have control of the payment of the wages, in which case the employer is the person having “control of the payment of such wages”. The Internal Revenue Service’s longstanding position is that when the section 3401(d)(1) exception applies, the liability for employment taxes and income tax withholding shifts from the common law employer to the person in control of the payment of wages.

In a recent decision involving a professional employer organization (PEO), the Eleventh Circuit created a new test for determining who has control of the payment of wages. The Circuit Court concluded that a contract between the PEO and its clients (the common law employers) could affect who controls the wage payments. The Circuit Court looked to both the language in the PEO’s contracts with its clients and how the relationship between the parties functioned, including whether the PEO generally issued wage payments before receiving payment from its clients.

### **Reasons for Change**

If the Eleventh Circuit’s interpretation of section 3401(d)(1) were universally adopted, it would provide common law employers a means to avoid liability for employment taxes and income tax withholding merely by entering into a contractual agreement that included certain minimal terms with a PEO or other intermediary to issue wage payments. The Circuit Court’s interpretation of section 3401(d)(1) undermines the purpose and objectives of the certified professional employer organization (CPEO) program, enacted at the end of 2014, that requires applicants to satisfy rigorous tax compliance and criminal background checks before becoming CPEOs. Furthermore, the Circuit Court’s interpretation could be (and has been) used by PEOs to claim income tax credits that would otherwise belong to common law employers. In some instances, both the PEO and the common law employer have claimed the same tax credit.

### **Proposal**

The proposal would amend section 3401(d)(1) to clarify the phrase “control of the payment of wages” in a manner that assures that a common law employer cannot avoid liability for employment taxes and income tax withholding except in limited circumstances consistent with the original legislative history and congressional intent. The proposal would be effective after December 31, 2024.

## **MODERNIZE RULES, INCLUDING THOSE FOR DIGITAL ASSETS**

### **APPLY THE WASH SALE RULES TO DIGITAL ASSETS AND ADDRESS RELATED PARTY TRANSACTIONS**

#### **Current Law**

Section 1091 of the Internal Revenue Code (Code) disallows a loss from a sale of stock or securities if the same or substantially identical stock or securities are purchased within 30 days before or after the sale (a “wash sale”) unless the taxpayer is a dealer in stock or securities and the loss is sustained in the ordinary course of its dealer business. If the stock or securities are purchased at a price that differs from the sale price of the stock or securities sold, appropriate adjustments are made to the basis of the purchased stock or securities. The holding period for the purchased stock or securities takes into account the holding period for the sold stock or securities. As a result, the effect of the wash sale rules ordinarily is to defer the recognition of a loss until the taxpayer finally disposes of the stock or securities. The wash sale rules also apply to sales of stock or securities where the taxpayer enters into a contract or option to buy the same or substantially identical stock or securities within the 30-day window, and to certain short sales of stock or securities. The wash sales are intended to ensure that taxpayers cannot recognize losses without exiting their position in a loss asset for a meaningful period of time.

The Internal Revenue Service treats a loss from a sale of stock or securities by a taxpayer that causes its individual retirement account or Roth IRA to purchase substantially identical stock or securities within 30 days of the sale as subject to the wash sale rule.<sup>61</sup>

Except as otherwise provided by the Secretary, brokers who report gross proceeds and basis from the sale of stock or securities determine a customer’s adjusted basis without regard to the wash sale rules, unless the transaction occurs in the same account with respect to identical securities.

#### **Reasons for Change**

Taxpayers with loss positions in digital assets are engaging in transactions that would be subject to the wash sale rules if the digital assets were subject to section 1091. For example, a taxpayer may sell a digital asset that is not considered a stock or security for wash sale purposes at a loss on one day and repurchase the same digital asset the next day. The same loss recognition rules should apply to digital assets held as investments or for trading as would apply for stocks and securities.

The wash sale rules should also be updated to provide statutory rules addressing related party transactions, and to reflect new types of financial instruments that have developed since the last amendments made to those rules. A *de minimis* rule for wash sales also may be appropriate, particularly in light of the expansion of the wash sale rules to digital assets, as the use of digital assets to make payments for goods and services may result in multiple small dispositions of

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<sup>61</sup> Revenue Ruling 2008-5, 2008-1 C.B. 271.

digital assets that may give rise to losses (or gains) within 30 days of an independent decision to purchase the same digital asset.

Broker reporting rules should be amended to reflect these changes to the wash sale rules.

### **Proposal**

The wash sale rules would be amended to add digital assets to the list of assets subject to the wash sale rules. Except as otherwise provided by the Secretary, the term “digital asset” means any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary.<sup>62</sup> Regulatory authority would be granted to the Secretary to treat any security as defined by section 475(c)(2), or any commodity as defined by section 475(e)(2), or other assets traded on an established market as subject to the wash sale rules as necessary to prevent abuse. The basis and holding period rules applicable to purchased assets would be revised to reflect the expanded scope of the wash sale rules. These expanded rules are not intended to apply to ordinary course business transactions. The Secretary would have authority to prescribe regulations defining the term “substantially identical”, to provide an exception to the application of the wash sale rules for *de minimis* losses for assets subject to the wash sale rule, and to provide an exception to the application of the wash sale rules for ordinary course business transactions (not including trading) involving digital assets.

The wash sale rules, as they apply to all assets and not only digital assets, would be modified with respect to transactions involving related persons, except as otherwise provided in regulations prescribed by the Secretary. In the case of any loss from a sale of assets subject to the wash sale rules and a purchase by a related party of the same or substantially identical assets within 30 days of the sale, the loss would be deferred until (a) the related party sells or otherwise disposes of the asset or such other time as specified by the Secretary, provided that the taxpayer and a related party do not reacquire the asset within 30 days before or after that sale or disposition, or (b) the parties cease to be related. A related party would include members of a taxpayer’s family and tax-favored accounts such as individual retirement accounts controlled by the taxpayer or the taxpayer’s spouse. Two entities would be related to each other if one controlled the other, directly or indirectly, or both were under the common control of either a third entity or the taxpayer and one or more family members. An individual would be related to an entity if the entity is controlled, directly or indirectly, by the individual and the individual’s family members. The Secretary would have authority to issue regulations expanding this definition as necessary to prevent abuse, to provide rules for transactions where a taxpayer sold assets at a loss and both the taxpayer and a related party acquired the same or substantially similar assets, and to coordinate the operation of the wash sale rules with other rules dealing with sales of loss property between related parties (sections 267 and 707).

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

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<sup>62</sup> This definition is the same as that provided in section 6045(g)(3)(D) of the Code. It is intended that the Secretary may exercise her authority to provide that the term “digital asset” has a meaning for wash sale purposes that is not identical to its meaning for purposes of regulations issued under section 6045.

The Secretary would have authority to require brokers to report such information as may be necessary or appropriate to implement the wash sale rules. Except as otherwise provided by the Secretary, brokers reporting a customer's adjusted basis on a disposition of a digital asset or other asset subject to the wash sale rules would report the basis of the asset without regard to the wash sale rules unless the sale of the loss asset and the transaction causing the wash sale rules to apply occur in the same account with respect to identical assets.

No inference is intended as to whether the losses claimed by taxpayers from wash sales of digital assets may be deducted under current law, or as to the proper treatment of transactions involving related parties under the wash sale rules under current law.

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

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

### **Current Law**

A common transaction in the securities market is a loan of securities. Owners of securities such as pension plans, mutual funds, insurance companies and other institutional investors lend their securities because they receive compensation for doing so. Persons wishing to take a trading position in the security (for example, to short the security as a hedge of another position or in order to benefit from an anticipated fall in price) will borrow the security in order to effect their transaction.

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

Several court cases have ruled that these securities loan nonrecognition rules do not apply to a number of tax-motivated transactions denominated as securities loans with non-market-standard terms, and that the transactions gave rise to taxable gain or loss on the transfer of the security.<sup>63</sup> While it is common in the securities lending market for a loan of securities to have a fixed term, in these cases, the security was loaned for a fixed or quasi-fixed term of unusually long duration, among other non-market-standard terms. In one case, the loaned security was a debt instrument that did not have coupons but was issued with significant original issue discount. The taxpayer did not take any amounts in respect of the accruing original issue discount into account during the term of the securities loan.<sup>64</sup>

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<sup>63</sup> *Samueli v. Commissioner*, 619 F.3d 399 (9<sup>th</sup> Cir. 2011) (tax-motivated transaction in which a taxpayer ostensibly loaned a debt instrument for most of its remaining term and did not qualify for non-recognition treatment under section 1058); *Sollberger v. Commissioner*, 691 F.3d 1119 (9<sup>th</sup> Cir. 2011) (tax-motivated transaction in which a taxpayer did not receive amounts in respect of distributions where security was nominally loaned for 7 years and did not qualify for non-recognition treatment under section 1058); *Lizzie Calloway*, 135 T.C. 26 (2010) (tax-avoidance transaction in which securities were nominally loaned for three years and did not meet the requirements of section 1058), affirmed on other grounds, 691 F.3d 1215 (11<sup>th</sup> Cir. 2012).

<sup>64</sup> *Samueli v. Commissioner*, 619 F.3d 399 (9<sup>th</sup> Cir. 2011).

## **Reasons for Change**

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

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

### **Expansion of asset classes**

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

Except in the case of digital assets that may also be treated as securities within the meaning of the definition described above, the securities loan nonrecognition rules do not apply to loans of digital assets. No other authority expressly addresses whether loans of assets other than securities give rise to taxable gain or loss. In light of the growing volume of loans of digital assets, rules addressing those transactions should be provided. Those rules should take into account differences between digital assets and securities. One example of those differences is that digital assets typically do not pay dividends or interest, but ownership of digital assets may result in other types of transfers of property to the owner such as hard forks<sup>65</sup> and airdrops.<sup>66</sup>

Another type of financial asset that taxpayers may lend, including pursuant to the terms of brokerage agreements, are equity interests in publicly traded partnerships. Although these equity interests function like securities for non-tax purposes, they are not securities for purposes of the securities loan nonrecognition rules. No rules address how such loans are treated, or how the partnership income that would be taken into account by the partner absent the loan is treated. The

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<sup>65</sup> A hard fork is a significant change to the protocol of a blockchain network that effectively results in two different digital assets with a common history. Holders of the digital asset in the original blockchain have access to both the original digital asset and the digital asset on the new blockchain after the hard fork.

<sup>66</sup> An airdrop means the transfer of a typically free digital asset to a taxpayer's wallet, generally with no or minimal involvement by the transferee, for example in order to promote or market a new digital asset.

Secretary should have authority to treat such loans as tax-free if the resulting treatment of partnership income is appropriate.

### Inclusion of income from loans of assets

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

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

### **Proposal**

The proposal would amend the securities loan nonrecognition rules to provide that they apply to loans of actively traded digital assets recorded on cryptographically secured distributed ledgers, provided that the loan has terms similar to those currently required for loans of securities. For example, if during the term of a loan the owner of the digital asset would have received other digital assets or other amounts if the loan had not taken place, the terms of the loan agreement should provide that those amounts will be transferred by the borrower to the lender, except as provided by the Secretary. The Secretary would have authority to determine when a digital asset is actively traded, and the authority to extend the rules to non-actively traded digital assets. The proposal also would provide authority to the Secretary to extend the securities loan nonrecognition rules to other assets such as interests in publicly traded partnerships.

The proposal would require that income that would be taken into account by the lender if the lender had continued to hold the loaned asset must be taken into account by the lender in a manner that clearly reflects income. The proposal would provide for appropriate basis adjustments to the loan contract and when the loaned asset is returned.

The proposal would clarify that fixed-term loans are subject to the securities loan nonrecognition rules if they would otherwise qualify, except as provided by the Secretary. For example, fixed-term loans entered into in the normal course of a securities lending business or the ordinary management of an investment portfolio ordinarily should be treated as nonrecognition

transactions, while a loan of a security for all or virtually all of its remaining term or an accommodation loan entered into to generate tax benefits should not be treated as a qualifying loan.

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

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

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

### **Current Law**

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

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

Under current law, any person doing business as a broker is required to report certain information about its customers to the IRS, such as the identity of each customer, the gross proceeds from sales of securities and certain commodities for such customer, and, for covered securities, cost basis information. A broker means a dealer, barter exchange, or a person who, for a consideration, regularly acts as a middleman with respect to property or services. Section 80603 of the Infrastructure Investment and Jobs Act of 2021 clarifies that a broker includes any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person. Except as otherwise provided by the Secretary, the term digital asset means any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary.

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

## **Reasons for Change**

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

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

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

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

## **Proposal**

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

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

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

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

## **REQUIRE REPORTING BY CERTAIN TAXPAYERS OF FOREIGN DIGITAL ASSET ACCOUNTS**

### **Current Law**

Section 6038D of the Internal Revenue Code (Code) requires any individual that holds an interest in one or more specified foreign financial assets with an aggregate value of at least \$50,000 during a taxable year to attach a statement with required information (currently provided on Internal Revenue Service (IRS) Form 8938, Statement of Specified Foreign Financial Asset) to the individual's tax return by the due date (including extensions) for that return. Treasury regulations under section 6038D also apply the requirements of this section to domestic entities formed or availed of for purposes of holding specified foreign financial assets.

A specified foreign financial asset means (a) a financial account maintained by a foreign financial institution, as those terms are defined by section 1471 of the Code, and (b) certain specified foreign assets not held in a financial account maintained by such a financial institution.

Information required to be reported includes the name and address of the financial institution where an account is maintained, the account number, as well as identifying information about assets not held in a financial account.

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

### **Reasons for Change**

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

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

### **Proposal**

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

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

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

## **AMEND THE MARK-TO-MARKET RULES TO INCLUDE DIGITAL ASSETS**

### **Current Law**

Section 475 of the Internal Revenue Code requires dealers in securities to use the mark-to-market method of accounting for inventory and non-inventory securities held at year end. For this purpose, a security includes corporate stock, interests in widely held or publicly traded partnerships and trusts, debt instruments, and certain derivative financial instruments. Dealers in commodities and traders in securities or commodities may elect to use the mark-to-market method. A commodity means any commodity which is actively traded, any notional principal contract with respect to any such commodity, and certain other derivative financial instruments and hedges with respect to such commodities.

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

### **Reasons for Change**

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

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

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

### **Proposal**

The proposal would add a third category of assets that may be marked-to-market at the election of a dealer or trader in those assets. Assets in the third category would be actively traded digital assets and derivatives on, or hedges of, those digital assets, under rules similar to those that apply

to actively traded commodities. The Secretary would have authority to determine which digital assets are treated as actively traded. The determination of whether a digital asset is actively traded would take into account relevant facts and circumstances, which may include whether the asset is regularly bought and sold for U.S. dollars or other fiat currencies, the volume of trading of the asset on exchanges that have reliable valuations, and the availability of reliable price quotations.

A digital asset would not be treated as a security or commodity for purposes of the mark-to-market rules and would therefore be eligible for mark-to-market treatment only under the rules applicable to the new third category of assets. No inference is intended as to the extent to which a digital asset may be eligible for mark-to-market treatment under current law.

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

## **IMPROVE BENEFITS TAX ADMINISTRATION**

### **RATIONALIZE FUNDING FOR POST-RETIREMENT MEDICAL AND LIFE INSURANCE BENEFITS**

#### **Current Law**

An employer can make deductible contributions to a welfare benefit fund, provided that the amount set aside does not exceed the account limit. In general, the account limit for a year is the amount needed to fund specified welfare benefits for the current year (including administrative expenses).<sup>67</sup> An exception to this limit allows an employer to accumulate an “additional reserve” for post-retirement medical and life insurance benefits. Under section 419A of the Internal Revenue Code, this reserve must be “funded over the working lives of the covered employees and actuarially determined on a level basis.”

In *Wells Fargo & Co. v. Commissioner of Internal Revenue Service*,<sup>68</sup> the U.S. Tax Court held that an employer establishing a reserve for post-retirement medical and life insurance benefits may make a lump sum contribution to fund the entire liability for these benefits for current retirees.

#### **Reasons for Change**

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

#### **Proposal**

The proposal would require post-retirement benefits to be funded over the longer of the working lives of the covered employees on a level basis or 10 years unless the employer commits to maintain those benefits over a period of at least 10 years.

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

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<sup>67</sup> The specified welfare benefits are (a) disability benefits, (b) medical benefits, (c) supplemental unemployment benefits or severance pay benefits, and (d) life insurance benefits.

<sup>68</sup> 120 T.C. No. 5, 120 T.C. 69, 2003 WL 301884 (U.S. Tax Ct. 2003).

## **CLARIFY TAX TREATMENT OF ON-DEMAND PAY ARRANGEMENTS**

### **Current Law**

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

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

### **Reasons for Change**

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

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

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

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

### **Proposal**

The proposal would amend section 7701 of the Code to provide a definition of an on-demand pay arrangement as an arrangement that allows employees to withdraw earned wages before their regularly scheduled pay dates. The proposal also would amend section 3401(b) of the Code to provide that the payroll period for on-demand pay arrangements is treated as a weekly payroll period, even if employees have access to their wages during the week. Further, the proposal would amend sections 3102, 3111, and 3301 of the Code to clarify that on-demand pay arrangements are not loans for Federal tax purposes. Finally, section 6302 of the Code would be amended to provide special payroll deposit rules for on-demand pay arrangements. The Secretary would be provided regulatory authority to implement the Code provisions addressing on-demand pay arrangements.

The proposal would be effective for calendar years and quarters beginning after December 31, 2024.

## **AMEND THE EXCISE TAX ON EMPLOYMENT-BASED GROUP HEALTH PLANS**

### **Current Law**

Section 4980D of the Internal Revenue Code (Code) imposes an excise tax on employers if their group health plans do not satisfy certain required standards, including: a) a prohibition on discrimination on the basis of health status; b) certain limitations on participant cost sharing, c) a requirement to cover no-cost preventative services, d) a requirement to cover children until they turn 26, and e) a requirement to cover mental health and substance use disorder services on a comparable basis to the coverage of medical and surgical services.

The excise tax is \$100 for each day the plan does not comply, for each person affected. An employer offering a non-compliant plan is required to self-report the excise tax liability by filing Form 8928, Return of Certain Excise Taxes Under Chapter 43 of the Code.

### **Reasons for Change**

Employers rarely have the expertise to administer their group health plans. Instead, employers hire outside companies, called third-party administrators (TPAs), to design and administer the plans on their behalf. The TPAs can be insurance companies or other types of firms.

Under current law, employers are generally liable for an excise tax under 4980D. Without potential liability for an excise tax or enforcement action, TPAs lack a strong incentive to facilitate compliance. They may fail to share critical information with employers or to help employers evaluate the health care benefits offered to their employees.

Amending 4980D to make TPAs liable for the tax in certain cases would make the excise tax more effective and increase compliance with the group health plan requirements.

### **Proposal**

The proposal would make a TPA liable for the excise tax instead of an employer to the extent that the TPA causes the employer's group health plan to be noncompliant with group health plan requirements.

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

## **EXTEND INTERNAL REVENUE SERVICE FUNDING**

### **EXTEND MANDATORY FUNDING PROVIDED TO THE INTERNAL REVENUE SERVICE THROUGH FISCAL YEAR 2034**

#### **Current Law**

The Inflation Reduction Act of 2022 (IRA) provided nearly \$80 billion in mandatory funding to the Internal Revenue Service (IRS) to complement the agency's annual discretionary appropriations. The Fiscal Responsibility Act of 2023 rescinded approximately \$1.4 billion of that funding. The adjusted baseline for the fiscal year 2025 Budget reflects an additional \$20.2 billion rescission of the IRA funding, consistent with the recently announced fiscal year 2024 topline agreement.

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

#### **Reasons for Change**

Before the enactment of the IRA, the IRS's operating budget had fallen by 18 percent in inflation-adjusted dollars between 2010 and 2021 while the number of returns filed had increased by 13 percent. This underfunding led to low levels of service and antiquated technology that failed to keep pace with the digital age. The lack of investment also resulted in a significant reduction in examination coverage, especially for large corporations and high-income individuals.<sup>69</sup> In addition, with the number of partnership returns growing by more than 30 percent during this period, the IRS was only able to audit 0.07 percent of partnership returns filed for tax year 2018.

The funding provided by the IRA will enable transformative improvements in all facets of tax administration over the next several years. As outlined in the *IRA Strategic Operating Plan*<sup>70</sup> (SOP) released by the IRS in April 2023, the funding will allow the IRS to dramatically improve customer service, modernize decades-old computer systems, and improve enforcement with respect to complex partnerships, large corporations, and high-income individuals. Together, this transformation will help ensure a fairer and more efficient tax system and reduce the country's sizable tax gap, projected to be \$688 billion in tax year 2021.

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<sup>69</sup> Congressional Budget Office, *Trends in the Internal Revenue Service's Funding and Enforcement*, July 2020. <https://www.cbo.gov/system/files/2020-07/56422-CBO-IRS-enforcement.pdf>

<sup>70</sup> IRS Publication 5744, *Internal Revenue Service Inflation Reduction Act Strategic Operating Plan: FY2023 – 2031*, April 2023. <https://www.irs.gov/pub/irs-pdf/p3744.pdf>

Already, the IRA has resulted in tangible benefits for taxpayers and tax administration. The IRS achieved significantly improved service in filing season 2023 at an 87 percent Level of Service on its main taxpayer help line and cut phone wait times to three minutes from 28 minutes. Since the enactment of the IRA, the IRS has opened or reopened 54 Taxpayer Assistance Centers as of January 2024 to provide more in-person help to taxpayers. In addition, the IRS launched a paperless processing initiative, enabling taxpayers to reply to more forms and letters online. To ensure large corporate, complex partnership, and high-income individual filers pay the taxes they owe, the IRS has sent compliance alerts to large foreign corporations, expanded its Large Corporate Compliance program, leveraged artificial intelligence to ramp up audits of large partnerships, and recovered over half a billion dollars from individual taxpayers with more than \$1 million in income who were seriously delinquent on their tax debt.

Long-term funding is essential for the IRS to continue to build on this progress. The ability to plan and implement changes over several years is critical to transform taxpayer services, modernize systems, and hire and train top talent to take on the most complex tax administration tasks, such as audits of complex partnerships and large corporations. Without further legislative action, the agency will be confronted with depleted IRA funding for the investments in taxpayer services and technology modernization in fiscal year 2026. There will also be an abrupt and severe decline in the IRS's enforcement budget beginning in fiscal year 2030, which would force the IRS to cut back on audits of large corporations, high-income individuals, and complex partnerships and thereby increase the Federal budget deficit. Extending mandatory funding through fiscal year 2034 would generate hundreds of billions of dollars in additional revenue.<sup>71</sup>

### **Proposal**

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

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<sup>71</sup> For more on the return on investment from IRS resources, see the Treasury and the IRS's recent analysis, *Return on Investment: Re-Examining Revenue Estimates for IRS Funding*, IRS Publication 5901, February 2024. <https://www.irs.gov/pub/irs-pdf/p5901.pdf>.

**PROPOSED MANDATORY FUNDING FOR THE IRS (\$ BILLION)**

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

<sup>1</sup>Technology and Operations Support (abbreviated "Tech & Op Supt") includes costs for activities previously charged to the Operations Support account, including costs for supporting the proposed enforcement functions. <sup>2</sup>

<sup>2</sup>Business Systems Modernization (abbreviated "BSM") includes costs to complete technology transformation begun with IRA funding.

## **TABLE OF REVENUE ESTIMATES**

**REVENUE ESTIMATES OF THE ADMINISTRATION'S FISCAL YEAR 2025 REVENUE PROPOSALS 1/12**

(fiscal years, in millions of dollars)

	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2025-29	2025-34
<b>REFORM BUSINESS TAXATION:</b>													
Raise the corporate income tax rate to 28 percent	74,646	122,474	125,105	128,114	128,624	128,353	129,396	137,888	144,919	150,028	155,040	632,670	1,349,941
Increase the corporate alternative minimum tax rate (CAMT) to 21 percent	10,050	13,543	11,759	12,264	12,675	13,119	13,672	14,238	14,800	15,379	15,980	63,360	137,429
Increase the excise tax rate on repurchase of corporate stock and close loopholes	3,863	15,344	14,980	14,936	15,184	15,792	16,458	17,167	17,912	18,691	19,502	76,236	165,966
Tax corporate distributions as dividends	0	110	160	170	180	190	200	210	230	240	250	810	1,940
Limit tax avoidance through inappropriate leveraging of parties to divisive reorganizations	0	279	826	1,614	2,550	3,569	4,645	5,769	6,937	8,150	9,408	8,838	43,747
Limit losses recognized in liquidation transactions	0	30	50	52	54	56	57	59	61	63	65	242	547
Prevent basis shifting by related parties through partnerships	0	3,851	5,537	3,999	2,325	563	-177	-215	-275	-341	-402	16,275	14,865
Conform definition of "control" with corporate affiliation test	0	447	651	667	681	695	709	719	727	733	736	3,141	6,765
Strengthen limitation on losses for noncorporate taxpayers	0	1,185	2,241	2,519	2,666	12,901	14,735	10,543	9,789	9,621	9,526	21,512	75,726
Expand limitation on deductibility of employee remuneration in excess of \$1 million	0	37,169	19,015	30,421	34,951	31,354	28,057	22,148	20,594	22,385	25,760	152,910	271,854
Prevent prison facility rent payments from contributing to qualification as a REIT													
<b>Subtotal, Reform Business Taxation</b>	<b>88,559</b>	<b>194,432</b>	<b>180,324</b>	<b>194,756</b>	<b>199,890</b>	<b>206,592</b>	<b>207,752</b>	<b>208,526</b>	<b>215,694</b>	<b>224,949</b>	<b>235,865</b>	<b>975,994</b>	<b>2,068,780</b>
<b>REFORM INTERNATIONAL TAXATION:</b>													
Revise the global minimum tax regime, limit inversions, and make related reforms	8,875	27,920	35,889	34,589	34,819	36,215	37,719	39,261	40,846	42,483	44,178	169,432	373,919
Adopt the undertaxed profits rule	0	9,596	14,541	14,065	14,389	14,181	14,088	13,837	13,752	13,916	13,948	66,772	136,313
Repeal the deduction for foreign-derived intangible income:													
<i>Repeal the deduction for foreign-derived intangible income</i>	0	13,938	17,669	14,213	14,639	15,078	15,531	15,997	16,477	16,971	17,480	75,537	157,993
<i>Provide additional support for research and development expenditures</i>	0	-13,938	-17,669	-14,213	-14,639	-15,078	-15,531	-15,997	-16,477	-16,971	-17,480	-75,537	-157,993
Subtotal, Repeal the deduction for foreign-derived intangible income	0	0	0	0	0	0	0	0	0	0	0	0	0
Revise the rules that allocate Subpart F income and GILTI between taxpayers to ensure that Subpart F income and GILTI are fully taxed	0	106	196	225	250	272	294	313	332	349	366	1,049	2,703

**REVENUE ESTIMATES OF THE ADMINISTRATION'S FISCAL YEAR 2025 REVENUE PROPOSALS /1/2**

(fiscal years, in millions of dollars)

	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2025-29	2025-34
Require a controlled foreign corporation's taxable year to match that of its majority U.S. shareholder	0	343	535	484	446	418	397	381	370	362	357	2,226	4,093
Limit foreign tax credits from sales of hybrid entities	0	2,691	4,281	4,038	3,918	3,910	4,002	4,113	4,219	4,341	4,481	18,838	39,994
Restrict deductions of excessive interest of members of financial reporting groups	0	64	54	39	22	5	0	0	0	0	0	184	184
Conform scope of portfolio interest exclusion for 10-percent shareholders to other tax rules													
Treat payments substituting for partnership effectively connected income as U.S. source dividends	0	1	2	4	5	6	6	7	8	8	9	18	56
Expand access to retroactive qualified electing fund elections													
Reform taxation of foreign fossil fuel income:													
<i>Modify foreign oil and gas extraction income and foreign oil related income rules</i>	0	184	310	318	329	340	352	363	377	393	409	1,481	3,375
<i>Modify tax rule for dual capacity taxpayers</i>	0	3,908	6,582	6,735	6,966	7,214	7,458	7,703	7,994	8,332	8,671	31,405	71,563
Subtotal, Reform taxation of foreign fossil fuel income	0	4,092	6,892	7,053	7,295	7,554	7,810	8,066	8,371	8,725	9,080	32,886	74,938
Provide tax incentives for locating jobs and business activity in the United States and remove tax deductions for shipping jobs overseas:													
<i>Provide tax credit for inshoring jobs to the United States</i>	0	-3	-6	-6	-7	-7	-8	-8	-8	-9	-9	-29	-71
<i>Remove tax deductions for shipping jobs overseas</i>	0	3	6	6	7	7	8	8	8	9	9	29	71
Subtotal, Provide tax incentives for locating jobs and business activity in the United States and remove tax deductions for shipping jobs overseas	0	0	0	0	0	0	0	0	0	0	0	0	0
<b>Subtotal, Reform International Taxation</b>	<b>8,875</b>	<b>44,813</b>	<b>62,390</b>	<b>60,497</b>	<b>61,144</b>	<b>62,561</b>	<b>64,316</b>	<b>65,978</b>	<b>67,898</b>	<b>70,184</b>	<b>72,419</b>	<b>291,405</b>	<b>632,200</b>
<b>SUPPORT HOUSING AND URBAN DEVELOPMENT:</b>													
Make permanent the new markets tax credit and formalize allocation incentives for investing in areas of higher distress	0	0	-97	-278	-483	-716	-990	-1,290	-1,602	-1,796	-1,866	-1,574	-9,118
Provide a neighborhood homes credit	0	-270	-1,145	-1,829	-1,963	-2,099	-2,183	-2,253	-2,304	-2,371	-2,428	-7,306	-18,845
Expand and enhance the low-income housing credit	0	-84	-354	-980	-1,918	-2,961	-4,010	-5,054	-6,090	-7,118	-8,077	-6,297	-36,646
<b>Subtotal, Support Housing and Urban Development</b>	<b>0</b>	<b>-354</b>	<b>-1,596</b>	<b>-3,087</b>	<b>-4,364</b>	<b>-5,776</b>	<b>-7,183</b>	<b>-8,597</b>	<b>-9,996</b>	<b>-11,285</b>	<b>-12,371</b>	<b>-15,177</b>	<b>-64,609</b>

**REVENUE ESTIMATES OF THE ADMINISTRATION'S FISCAL YEAR 2025 REVENUE PROPOSALS 1/12**

(fiscal years, in millions of dollars)

	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2025-29	2025-34
<b>MODIFY ENERGY TAXES:</b>													
Eliminate fossil fuel tax preferences:													
Repeal the enhanced oil recovery credit for eligible costs attributable to a qualified enhanced oil recovery project						no revenue effect							
Repeal the credit for oil and gas produced from marginal wells	0	19	34	26	14	4	0	0	0	0	0	97	97
Repeal the expensing of intangible drilling costs	0	1,790	2,652	1,971	1,234	478	204	265	334	406	448	8,125	9,782
Repeal the deduction for costs paid or incurred for any qualified tertiary injectant used as part of tertiary recovery method	0	6	8	9	9	9	9	9	9	9	9	41	86
Repeal the exception to passive loss limitations provided to working interests in oil and natural gas properties	0	5	9	8	8	8	8	7	7	7	7	38	74
Repeal the use of percentage depletion with respect to oil and gas wells	0	880	1,476	1,493	1,521	1,562	1,611	1,671	1,741	1,820	1,900	6,932	15,675
Increase geological and geophysical expenditure amortization period for independent producers	0	65	251	414	455	448	439	432	419	395	360	1,633	3,678
Repeal expensing of exploration and development costs	0	148	220	164	102	39	17	22	28	34	38	673	812
Repeal percentage depletion for hard mineral fossil fuels	0	57	103	112	122	128	136	145	148	148	153	522	1,252
Repeal capital gains treatment for royalties	0	26	54	56	54	53	52	53	50	49	48	243	495
Repeal the exemption from the corporate income tax for fossil fuel publicly traded partnerships	0	0	0	0	0	0	75	148	186	220	251	0	880
Repeal the Oil Spill Liability Trust Fund and Superfund excise tax exemption for crude oil derived from bitumen and kerogen-rich rock	0	115	160	166	172	179	183	186	192	198	200	792	1,751
Repeal accelerated amortization for air pollution control facilities	0	12	30	47	62	77	91	103	101	90	79	228	692
Subtotal, Eliminate fossil fuel tax preferences	0	3,123	4,997	4,466	3,753	2,985	2,825	3,041	3,215	3,376	3,493	19,324	35,274
Eliminate drawbacks on petroleum taxes that finance the Oil Spill Liability Trust Fund and Superfund	0	149	202	206	210	213	216	218	222	224	227	980	2,087
Impose digital asset mining energy excise tax	0	107	302	533	670	744	832	935	1,052	1,197	1,361	2,356	7,733
<b>Subtotal, Modify Energy Taxes</b>	<b>0</b>	<b>3,379</b>	<b>5,501</b>	<b>5,205</b>	<b>4,633</b>	<b>3,942</b>	<b>3,873</b>	<b>4,194</b>	<b>4,489</b>	<b>4,797</b>	<b>5,081</b>	<b>22,660</b>	<b>45,094</b>

**REVENUE ESTIMATES OF THE ADMINISTRATION'S FISCAL YEAR 2025 REVENUE PROPOSALS /1/2**

(fiscal years, in millions of dollars)

	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2025-29	2025-34
<b>STRENGTHEN TAXATION OF HIGH-INCOME TAXPAYERS:</b>													
Apply the net investment income tax to pass-through business income of high-income taxpayers	8,496	38,302	29,950	31,931	34,819	37,435	39,950	42,143	43,986	46,126	48,579	172,437	393,221
Increase the net investment income tax rate and additional Medicare tax rate for high-income taxpayers	8,394	42,920	31,327	32,285	34,710	37,224	39,822	42,450	44,963	47,602	50,487	178,466	403,790
Increase the top marginal income tax rate for high-income earners	9,871	75,419	31,189	13,798	14,939	15,859	16,818	17,833	18,885	19,997	21,187	151,204	245,924
Reform the taxation of capital income	0	18,031	23,713	25,164	26,417	27,624	29,050	30,727	32,158	33,758	41,941	120,949	288,583
Impose a minimum income tax on the wealthiest taxpayers	0	0	50,310	56,387	59,430	60,451	59,974	59,331	53,057	50,215	53,513	226,578	502,668
<b>Subtotal, Strengthen Taxation of High-Income Taxpayers</b>	<b>26,761</b>	<b>174,672</b>	<b>166,489</b>	<b>159,565</b>	<b>170,315</b>	<b>178,593</b>	<b>185,614</b>	<b>192,484</b>	<b>193,049</b>	<b>197,698</b>	<b>215,707</b>	<b>849,634</b>	<b>1,834,186</b>
<b>MODIFY RULES RELATING TO RETIREMENT PLANS:</b>													
Prevent excessive accumulations by high-income taxpayers in tax-favored retirement accounts and make other reforms	0	6,926	6,142	3,402	1,992	1,278	931	776	724	726	759	19,740	23,656
<b>Subtotal, Modify Rules Relating to Retirement Plans</b>	<b>0</b>	<b>6,926</b>	<b>6,142</b>	<b>3,402</b>	<b>1,992</b>	<b>1,278</b>	<b>931</b>	<b>776</b>	<b>724</b>	<b>726</b>	<b>759</b>	<b>19,740</b>	<b>23,656</b>
<b>SUPPORT WORKERS, FAMILIES, AND ECONOMIC SECURITY:</b>													
Expand the child credit, and make permanent full refundability and advanceability /3	-5,409	-209,890	-11,210	-7,769	-11,376	-11,586	-11,827	-12,157	-12,372	-12,717	-9,120	-251,831	-310,024
Restore and make permanent the American Rescue Plan expansion of the earned income tax credit for workers without qualifying children /3	-388	-15,330	-15,770	-15,998	-16,126	-16,310	-16,451	-16,503	-16,587	-16,695	-16,783	-79,534	-162,553
Make permanent the Inflation Reduction Act expansion of health insurance premium tax credits /3	0	0	-14,884	-21,751	-23,366	-24,699	-26,308	-27,059	-28,489	-30,481	-32,535	-84,700	-229,572
Make the adoption tax credit refundable and allow certain guardianship arrangements to qualify /3	0	-2	-2,642	-1,420	-1,186	-1,183	-1,180	-1,186	-1,187	-1,173	-1,182	-6,433	-12,341
Make permanent the income exclusion for forgiven student debt /3	0	0	0	-17	-37	-234	-252	-270	-290	-311	-333	-290	-1,746
Extend tax-preferred treatment to certain Federal and tribal scholarship and education loan programs	0	-62	-104	-114	-120	-123	-127	-130	-133	-134	-136	-523	-1,183

**REVENUE ESTIMATES OF THE ADMINISTRATION'S FISCAL YEAR 2025 REVENUE PROPOSALS /1/2**

(fiscal years, in millions of dollars)

	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2025-29	2025-34
Increase the employer-provided childcare tax credit for businesses	0	-19	-37	-38	-40	-41	-43	-43	-44	-44	-44	-175	-393
Improve the design of the work opportunity tax credit to promote longer-term employment	0	85	93	22	12	9	7	5	4	3	2	221	242
Provide tax credits for certain first-time homebuyers and home sellers:													
<i>Provide a tax credit for certain first-time homebuyers /3</i>	-234	-12,232	-14,066	-5,005	218	69	0	0	0	0	0	-31,016	-31,016
<i>Provide a tax credit for certain home sellers /3</i>	-476	-16,285	0	0	0	0	0	0	0	0	0	-16,285	-16,285
Subtotal, Provide tax credits for certain first-time homebuyers and home sellers	-710	-28,517	-14,066	-5,005	218	69	0	0	0	0	0	-47,301	-47,301
<b>Subtotal, Support Workers, Families, and Economic Security</b>	<b>-6,507</b>	<b>-253,735</b>	<b>-58,622</b>	<b>-52,090</b>	<b>-52,021</b>	<b>-54,098</b>	<b>-56,181</b>	<b>-57,343</b>	<b>-59,098</b>	<b>-61,552</b>	<b>-60,131</b>	<b>-470,566</b>	<b>-764,871</b>

**MODIFY ESTATE AND GIFT TAXATION:**

Improve tax administration for trusts and decedents' estates	0	9	79	83	96	112	130	150	174	199	227	379	1,259
Limit duration of generation-skipping transfer tax exemption								no revenue effect					
Modify income, estate, gift, and generation-skipping transfer tax rules for certain trusts	0	1,290	2,625	5,032	6,855	8,871	10,566	10,749	11,608	12,587	13,567	24,673	83,750
Revise rules for valuation of certain property	0	331	955	1,025	1,139	1,225	1,296	1,390	1,493	1,613	1,745	4,675	12,212
<b>Subtotal, Modify Estate and Gift Taxation</b>	<b>0</b>	<b>1,630</b>	<b>3,659</b>	<b>6,140</b>	<b>8,090</b>	<b>10,208</b>	<b>11,992</b>	<b>12,289</b>	<b>13,275</b>	<b>14,399</b>	<b>15,539</b>	<b>29,727</b>	<b>97,221</b>

**CLOSE LOOPHOLES:**

Tax carried (profits) interests as ordinary income	0	397	661	659	657	664	677	691	705	719	733	3,038	6,563
Repeal deferral of gain from like-kind exchanges	0	680	1,870	1,926	1,984	2,044	2,104	2,169	2,232	2,300	2,369	8,504	19,678
Require 100 percent recapture of depreciation deductions as ordinary income for certain depreciable real property	0	41	128	267	417	579	755	946	1,151	1,373	1,611	1,432	7,268
Modify depreciation rules for purchases of general aviation passenger aircraft	0	46	141	206	217	207	175	142	125	117	116	817	1,492
Limit use of donor advised funds to avoid a private foundation payout requirement	0	65	61	42	27	14	11	12	12	13	13	209	270
Exclude payments to disqualified persons from counting toward private foundation payout requirement	0	1	2	1	1	1	1	0	0	0	0	6	7

**REVENUE ESTIMATES OF THE ADMINISTRATION'S FISCAL YEAR 2025 REVENUE PROPOSALS /1/2**

(fiscal years, in millions of dollars)

	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2025-29	2025-34
Extend the period for assessment of tax for certain Qualified Opportunity Fund investors	11	26	19	15	11	10	9	6	2	0	0	81	98
Impose ownership diversification requirement for small insurance company election	0	272	908	1,023	1,097	1,165	1,235	1,310	1,395	1,497	1,587	4,465	11,489
Expand pro rata interest expense disallowance for business-owned life insurance	0	609	618	646	668	691	717	748	780	813	850	3,232	7,140
Modify rules for insurance products that fail the statutory definition of a life insurance contract	0	3	10	12	14	17	19	22	26	29	33	56	185
Limit tax benefits for private placement life insurance and similar contracts	0	140	208	288	387	505	651	825	1,032	1,276	1,567	1,528	6,879
Correct drafting errors in the taxation of insurance companies under the Tax Cuts and Jobs Act of 2017	0	77	105	111	107	73	56	47	39	35	32	473	682
Define the term "ultimate purchaser" for purposes of diesel fuel exportation	0	7	9	11	13	15	19	21	23	26	28	55	172
Limit the deduction for the transfer of property to the value of property actually included in income	0	85	128	130	136	141	147	154	159	167	173	620	1,420
Reform excise taxes on business aviation	0	44	106	169	235	300	322	325	329	332	336	854	2,498
<b>Subtotal, Close Loopholes</b>	<b>11</b>	<b>2,493</b>	<b>4,974</b>	<b>5,506</b>	<b>5,971</b>	<b>6,426</b>	<b>6,898</b>	<b>7,418</b>	<b>8,010</b>	<b>8,697</b>	<b>9,448</b>	<b>25,370</b>	<b>65,841</b>

**IMPROVE TAX ADMINISTRATION:**

Enhance accuracy of tax information:													
<i>Expand the Secretary's authority to require electronic filing for forms and returns</i>													
<i>Improve information reporting for reportable payments subject to backup withholding</i>													
Subtotal, Enhance accuracy of tax information	0	41	95	161	221	231	241	252	263	275	301	749	2,081
Amend the centralized partnership audit regime to permit the carryover of a reduction in tax that exceeds a partner's tax liability	0	-5	-5	-6	-6	-7	-7	-7	-7	-8	-8	-29	-66
Incorporate chapters 2/2A in centralized partnership audit regime proceedings	0	127	49	8	8	9	9	10	10	10	10	201	250
Allow partnerships to resolve audits earlier	0	148	152	154	160	162	175	171	178	185	194	776	1,679
Modify requisite supervisory approval of penalty included in notice	0	6	15	10	2	2	2	2	2	2	2	35	45
Modify the requirement that general counsel review certain offers in compromise	0	6	15	10	2	2	2	2	2	2	2	35	45

**REVENUE ESTIMATES OF THE ADMINISTRATION'S FISCAL YEAR 2025 REVENUE PROPOSALS 1/1/2**

(fiscal years, in millions of dollars)

	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2025-29	2025-34
Simplify foreign exchange gain or loss rules and exchange rate rules for individuals	0	-1	-2	-3	-3	-3	-3	-3	-3	-4	-4	-12	-29
Modernize reporting with respect to foreign tax credits to reduce burden and increase compliance	0	-10	-31	-34	-34	-34	-35	-35	-36	-39	-40	-143	-328
Authorize limited sharing of business tax return information to measure the economy more accurately						no revenue effect							
Expand TIN matching and improve child support enforcement						negligible revenue effect							
Clarify that information previously disclosed in a judicial or administrative proceeding is not return information	0	2	2	2	2	2	2	2	2	2	2	10	20
Require earlier electronic filing deadlines for certain information returns	0	175	153	129	118	106	75	59	41	43	45	681	944
Allow the Tax Court to review all evidence in innocent spouse relief cases						negligible revenue effect							
Permit electronically provided notices						negligible revenue effect							
Reform Federal grants to low-income taxpayer clinics						negligible revenue effect							
<b>Subtotal, Improve Tax Administration</b>	<b>0</b>	<b>483</b>	<b>428</b>	<b>421</b>	<b>468</b>	<b>468</b>	<b>459</b>	<b>451</b>	<b>450</b>	<b>466</b>	<b>502</b>	<b>2,268</b>	<b>4,596</b>
<b>IMPROVE TAX COMPLIANCE:</b>													
Address taxpayer noncompliance with listed transactions:													
<i>Extend statute of limitations for listed transactions</i>	0	23	51	64	78	76	74	73	72	70	69	292	650
<i>Impose liability on shareholders to collect unpaid income taxes of applicable corporations</i>	0	492	513	534	556	579	604	630	658	686	716	2,674	5,968
Subtotal, Address taxpayer noncompliance with listed transactions	0	515	564	598	634	655	678	703	730	756	785	2,966	6,618
Impose an affirmative requirement to disclose a position contrary to a regulation	0	9	11	11	12	14	14	15	15	16	18	57	135
Require employers to withhold tax on failed nonqualified deferred compensation plans	0	206	215	225	235	245	256	267	279	291	304	1,126	2,523
Extend to six years the statute of limitations for certain tax assessments						negligible revenue effect							
Increase the statute of limitations on assessment of the COVID-related paid leave and employee retention tax credits /3	42	557	1,624	1,327	218	0	0	0	0	0	0	3,726	3,726

**REVENUE ESTIMATES OF THE ADMINISTRATION'S FISCAL YEAR 2025 REVENUE PROPOSALS /1/2**

(fiscal years, in millions of dollars)

	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2025-29	2025-34
Impose penalties for inaccurate or fraudulent employment tax returns /3	0	1,704	95	45	11	0	0	0	0	0	0	1,855	1,855
Expand and increase penalties for noncompliant return preparation and e-filing and authorize IRS oversight of paid preparers:													
Expand and increase penalties for return preparation and e-filing /3	0	40	53	49	50	55	60	66	72	78	85	247	608
Grant authority to IRS for oversight of paid preparers /3	0	28	51	70	87	98	100	100	99	98	97	334	828
Subtotal, Expand and increase penalties for noncompliant return preparation and e-filing and authorize IRS oversight of paid preparers	0	68	104	119	137	153	160	166	171	176	182	581	1,436
Make repeated willful failure to file a tax return a felony for those with significant tax liability													
Expand IRS summons authority for large partnerships	0	143	244	255	265	276	288	300	313	326	340	1,183	2,750
Address compliance in connection with tax responsibilities of expatriates	0	0	1	2	3	4	5	5	4	4	4	10	32
Define control of the payment of wage													
<b>Subtotal, Improve Tax Compliance</b>	<b>42</b>	<b>3,202</b>	<b>2,858</b>	<b>2,582</b>	<b>1,515</b>	<b>1,347</b>	<b>1,401</b>	<b>1,456</b>	<b>1,512</b>	<b>1,569</b>	<b>1,633</b>	<b>11,504</b>	<b>19,075</b>

**MODERNIZE RULES, INCLUDING THOSE FOR DIGITAL ASSETS:**

Apply the wash sale rules to digital assets and address related party transactions	0	1,034	1,774	2,151	2,313	2,515	2,776	2,979	3,201	3,433	3,650	9,787	25,826
Modernize rules treating loans of securities as tax-free to include other asset classes and address income inclusion													
Provide for information reporting by certain financial institutions and digital asset brokers for purposes of exchange of information	0	239	279	297	316	334	357	382	403	427	451	1,465	3,485
Require reporting by certain taxpayers of foreign digital asset accounts	0	375	439	466	497	526	561	600	634	671	708	2,303	5,477
Amend the mark-to-market rules to include digital assets	0	8,047	-58	-64	-70	-77	-85	-94	-103	-113	-125	7,778	7,258
<b>Subtotal, Modernize Rules, Including Those for Digital Assets</b>	<b>0</b>	<b>9,695</b>	<b>2,434</b>	<b>2,850</b>	<b>3,056</b>	<b>3,298</b>	<b>3,609</b>	<b>3,867</b>	<b>4,135</b>	<b>4,418</b>	<b>4,684</b>	<b>21,333</b>	<b>42,046</b>

**REVENUE ESTIMATES OF THE ADMINISTRATION'S FISCAL YEAR 2025 REVENUE PROPOSALS /1/2**

(fiscal years, in millions of dollars)

	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2025-29	2025-34
<b>IMPROVE BENEFITS TAX ADMINISTRATION:</b>													
Rationalize funding for post-retirement medical and life insurance benefits							negligible revenue effect						
Clarify tax treatment of on-demand pay arrangements							negligible revenue effect						
Amend the excise tax on employment-based group health plans							negligible revenue effect						
<b>Subtotal, Improve Benefits Tax Administration</b>						<b>3,046</b>	<b>42,691</b>	<b>60,911</b>	<b>70,716</b>	<b>80,001</b>	<b>83,648</b>	<b>3,046</b>	<b>341,013</b>
<b>EXTEND INTERNAL REVENUE SERVICE FUNDING:</b>													
Extend mandatory funding provided to the Internal Revenue Service through fiscal year 2034 /4	0	0	0	0	0	3,046	42,691	60,911	70,716	80,001	83,648	3,046	341,013
<b>Subtotal, Extend Internal Revenue Service Funding</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>3,046</b>	<b>42,691</b>	<b>60,911</b>	<b>70,716</b>	<b>80,001</b>	<b>83,648</b>	<b>3,046</b>	<b>341,013</b>
<b>TOTAL, ADMINISTRATION'S FISCAL YEAR 2025 REVENUE PROPOSALS:</b>	<b>117,741</b>	<b>187,636</b>	<b>374,981</b>	<b>385,747</b>	<b>400,689</b>	<b>417,885</b>	<b>466,172</b>	<b>492,410</b>	<b>510,858</b>	<b>535,067</b>	<b>572,783</b>	<b>1,766,938</b>	<b>4,344,228</b>
Total, receipt effect	117,813	398,248	446,290	426,114	438,900	457,164	506,515	533,412	552,687	578,100	613,670	2,166,716	4,951,100
Total, outlay effect	-72	-210,612	-71,309	-40,367	-38,211	-39,279	-40,343	-41,002	-41,829	-43,033	-40,887	-399,778	-606,872

**NOTES:**

- Presentation in this table does not necessarily reflect the order in which these proposals were estimated.
- The FY 2025 Budget includes additional receipts effects from the proposals to: extend surprise billing protections to ground ambulances, improve access to behavioral healthcare in the private insurance market, require coverage of three primary care visits and three behavioral health visits without cost-sharing, limit cost-sharing for insulin at \$35 per month, require 12 months of Medicaid postpartum coverage, expand the continuous eligibility requirement for all children in Medicaid and CHIP from 12 to 36 months, provide continuous eligibility for children in Medicaid and CHIP from birth until they turn age 6, prohibit enrollment fees and waiting periods in CHIP, expand Medicare drug inflationary rebates to include the commercial market, increase civil penalties for labor law violations, establish Electronic Visa Update System user fee, fund Unemployment Insurance program integrity, and increase FHLB contribution to the Affordable Housing Program.
- This proposal affects both receipts and outlays. Both effects are shown above. The outlay effects included in these estimates are listed below.

Expand the child credit, and make permanent full refundability and advanceability	-80	-186,320	-39,499	-8,623	-8,187	-8,188	-8,200	-8,261	-8,176	-8,195	-4,858	-250,817	-288,507
Restore and make permanent the American Rescue Plan expansion of the earned income tax credit for workers without qualifying children	-2	-13,779	-14,068	-13,955	-14,097	-14,288	-14,439	-14,504	-14,610	-14,722	-14,815	-70,187	-143,277
Make permanent the Inflation Reduction Act expansion of health insurance premium tax credits	0	0	-9,333	-13,774	-14,785	-15,571	-16,469	-16,991	-17,789	-18,865	-19,948	-53,463	-143,525

**REVENUE ESTIMATES OF THE ADMINISTRATION'S FISCAL YEAR 2025 REVENUE PROPOSALS /1/2**

(fiscal years, in millions of dollars)

	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2025-29	2025-34
Make the adoption tax credit refundable and allow certain guardianship arrangements to qualify	0	0	-2,653	-1,481	-1,252	-1,253	-1,254	-1,265	-1,273	-1,268	-1,282	-6,639	-12,981
Make permanent the income exclusion for forgiven student debt	0	0	0	-2	-2	-23	-27	-29	-30	-32	-35	-27	-180
Provide a tax credit for certain first-time homebuyers	0	-4,048	-6,246	-2,943	0	0	0	0	0	0	0	-13,237	-13,237
Provide a tax credit for certain home sellers	0	-7,239	0	0	0	0	0	0	0	0	0	-7,239	-7,239
Increase the statute of limitations on assessment of the COVID-related paid leave and employee retention tax credits	10	144	434	372	72	0	0	0	0	0	0	1,022	1,022
Impose penalties for inaccurate or fraudulent employment tax returns	0	596	10	0	0	0	0	0	0	0	0	606	606
Expand and increase penalties for return preparation and e-filing	0	24	29	21	19	20	22	24	26	28	30	113	243
Grant authority to IRS for oversight of paid preparers	0	10	17	18	21	24	24	24	23	21	21	90	203

4. Estimate is for gross revenue only. Including outlays for Internal Revenue Service funding, the estimated net total over ten years is \$236,710 million.