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Biden Administration Releases 2024 Budget, Green Book

The Biden administration on March 9 unveiled a budget proposal for fiscal 2024 that would reduce the federal deficit by nearly \$3 trillion over 10 years, primarily by raising taxes on high-net-worth individuals and large corporations.

The proposed budget would increase the U.S. corporate income tax rate from 21% to 28%, and the top individual ordinary income tax rate from 37% to 39.6%. The international tax rules would be amended to raise the tax rate on the foreign earnings of U.S. multinational corporations, and the corporate stock repurchase excise tax that was enacted as part of the Inflation Reduction Act of 2022 would increase from 1% to 4%.

The White House simultaneously released the General Explanations of the Administration's Fiscal Year 2024 Revenue Proposal, known as the "Green Book," which provides explanations and detailed estimates from the Treasury Department for the administration's revenue proposals.

The following is a more detailed description of the administration's proposals that would affect business entities, individuals, and the international tax regime.

CORPORATE AND BUSINESS TAX PROVISIONS

Raise Corporate Income Tax Rate to 28%

C corporations pay an entity-level income tax at a flat rate of 21%, and their shareholders pay a second level of tax on distributions that are made from either current or accumulated (past) earnings and profits of the corporation.

The proposal would increase the tax rate for C corporations from 21% to 28%, thus restoring one-half of the tax-rate reduction that became effective after December 31, 2017 (from 35% to 21%).

This proposal would be effective for taxable years beginning after December 31, 2022. However, for fiscal-year taxpayers with taxable years beginning before January 1, 2023, and ending after December 31, 2022, the corporate income tax rate would be equal to 21% plus 7% times the portion of the taxable year that occurs in 2023.

Many multinational corporations pay effective tax rates on worldwide income that are far below the statutory rate, due in part to low-taxed foreign income. The proposal would keep the global intangible low-taxed income (GILTI) deduction constant, raising the effective GILTI rate in proportion to the increase in the corporate rate through the application of the higher rate on the portion not excluded from the deduction, or 14%. Separate proposals applicable to GILTI would further increase the effective rate of tax on such income (see discussion below).

Increase the Excise Tax Rate on Repurchases of Corporate Stock

The Inflation Reduction Act imposed a 1% excise tax on stock repurchases by domestic corporations whose stock is publicly traded. Among other provisions, the amount subject to the tax is subject to a de minimis exception, is offset by certain issuances of stock by the corporation and includes some transactions that are considered to be economically similar to a redemption by a corporation of its own stock. The tax also applies to acquisitions of the corporation's stock by certain specified affiliates, to certain subsidiaries of foreign corporations, and to certain non-U.S. corporations subject to the inversion rules.

The proposal would quadruple the excise tax rate to 4%, applicable to repurchases of stock after December 31, 2022, the original effective date of the tax.

Tax Corporate Distributions as Dividends

Distributions made by a corporation with respect to its stock are generally subject to a three-tier treatment, consisting of (1) taxable dividends to the extent of the corporation's current or accumulated earnings and profits, (2) recovery of basis to the extent the distribution exceeds the amount taxable as a dividend, and (3) gain from the exchange of stock to the extent the distribution exceeds the amount subject to the first two categories.

The proposals are intended to limit or prevent the use of some transactions that have been used by taxpayers to reduce the portion of their distributions treated as a taxable dividend. If enacted, they would apply to (1) distributions of certain high-basis stock owned by the distributing corporation, (2) certain leveraged distributions, (3) purchases of "hook stock" by a subsidiary of the issuing corporation, and (4) the use of the "boot-within-gain" limitation applicable to reorganization transactions.

Most of the proposals would become effective for transactions occurring after December 31, 2023. The first of the four changes described above would be effective as of the date of enactment.

Limit Tax Avoidance Through Leveraging of Parties to Divisive Reorganizations

The divisive reorganization provisions of Sections 368(a)(1)(D) and 355 (commonly referred to as "spin-offs," "split-offs" or "split-ups") represent one of the few exceptions in the Code that permit a corporation to distribute appreciated property without the recognition of gain. In the most straightforward transaction, the distributing corporation ("Distributing") transfers property to a controlled corporation ("Controlled") and then distributes all the stock of Controlled to its shareholders. Provided that all the applicable statutory and regulatory requirements are satisfied, none of Distributing, Controlled or the shareholders of Distributing will recognize any gain or loss from the transactions.

Taxpayers have devised a number of transactions in connection with a divisive reorganization that are collectively referred to as "monetization transactions." These transactions have the effect of extracting value from Controlled prior to the distribution of the Controlled stock. Such transactions include (1) the distribution of Controlled debt to Distributing, (2) the transfer of money or other property by Controlled to Distributing, and (c) the assumption by Controlled of liabilities of Distributing. If properly structured within applicable guidelines and safe harbors, Distributing will not recognize any gain from these monetization transactions.

The proposal would further restrict (but not eliminate) the ability of taxpayers to use monetization transactions to reduce or eliminate gain realized by Distributing. The proposal would be effective for transactions occurring after the date of enactment, with an exception for transactions described in ruling requests submitted to the Internal Revenue Service on or before the date of enactment.

Limit Losses Recognized in Liquidation Transactions

In general, when a corporation distributes its property in complete liquidation, gain or loss is recognized to both the distributing corporation and its shareholders. The corporation recognizes gain or loss as if its property had been sold to the shareholders for its fair market value. The shareholders recognize gain or loss based on the difference between the amount realized and their tax basis in the stock. The Section 267 rules that would disallow or defer the recognition of losses from the sale of property between related persons do not apply to losses arising out of the complete liquidation of corporations.

One important exception to this rule applies to "subsidiary liquidations," in which a corporate shareholder owns at least 80% of the subsidiary's stock (by vote and value).

In this case, the corporate shareholder does not recognize gain or loss on the liquidation, and the liquidating corporation does not recognize gain or loss to the extent that property is distributed to the corporate shareholder.

Because neither gains nor losses are recognized under this exception to the general rule, taxpayers with a built-in loss have structured pre-liquidation transactions in an effort to claim a deductible loss upon liquidation. Stated differently, taxpayers seek to avoid the non-recognition rules applicable to subsidiary liquidations to use the rules for taxable liquidations of corporations. Such transactions frequently involve the transfer of more than 20% of the subsidiary's stock to a related party, such that the parent does not directly own at least 80% of the subsidiary's stock at the time of liquidation.

The proposal would expand the scope of the loss-disallowance provisions so that they would apply to losses from the complete liquidation of a corporation when the assets of the liquidating corporation remain in the "controlled group" after the liquidation. The term "controlled group" generally includes corporations under common control using a 50% stock ownership level. Although the proposal would not change the requirements for a tax-free subsidiary liquidation, it would effectively defer the recognition of losses in those cases.

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

Conform Definition of "Control" for Corporate Transaction Testing

Most large businesses operate through parent-subsidiary structures in which separate legal entities are owned, directly or indirectly, by a common parent. Domestic parent-subsidiary groups may file a single consolidated federal income tax return if each lower-tier corporation is a member of an "affiliated group" under the common parent. One benefit of filing a consolidated return, among others, is that an affiliate's losses can offset the income of other affiliates.

A related corporation is considered to be a member of an "affiliated group" when there is direct and indirect ownership of stock by a common parent possessing at least 80% of the total voting power of the stock of the corporation and at least 80% of the total value of the stock of the corporation. Certain "plain vanilla" preferred stock is not taken into account in determining the existence of an affiliated group.

However, the definition of control for purposes of other corporate provisions is notably different.

These other transactions include tax-free contributions to capital under Section 351, certain reorganization transactions under Section 368 and divisive reorganizations under Section 355. For purposes of these other corporate tax provisions, "control" is defined under Section 368(c) as ownership of stock possessing at least 80% of the total combined voting power of all classes of voting stock and at least 80% of the total number of shares of each other class of outstanding stock. This requirement thus includes both voting and nonvoting stock of the corporation. Importantly, it does not contain a value component, in contrast to the definition of an "affiliated group."

The proposal would conform the control test under Section 368(c) with the affiliation test under Section 1504(a)(2) by uniformly applying the "affiliated group" definition to most corporate transactions. Thus, the Section 368(c) definition of "control" would also require ownership of at least 80% of the total voting power and at least 80% of the total value of the stock of a corporation. The exception for "plain vanilla" preferred stock would continue to apply.

The proposal would be effective for transactions occurring after December 31, 2023.

Strengthen Limitation on Losses for Noncorporate Taxpayers

Section 461(l) imposes a limitation on the ability of noncorporate taxpayers to use business losses to offset other sources of income. Indexed annually for inflation, the annual limitation for 2023 is \$578,000 for married individuals filing a joint return and \$289,000 for all other taxpayers. Any net business losses in excess of this limitation constitute an excess business loss that is carried forward to subsequent taxable years subject to the rules applicable to net operating losses. These limitations are applied after basis limitations (for pass-through entities), at-risk limitations and limitations on losses from passive activities.

After being extended twice, under current law, these limitations would cease to apply for taxable years beginning after December 31, 2028.

The proposal would make Section 461(l) permanent and would eliminate the provision that subjects excess business losses from a prior taxable year to the rules applicable to net operating losses in subsequent years. Thus, the Section 461(l) limitations would apply to the initial year of the excess business loss and to any subsequent taxable years to which such losses are carried.

Accelerate and Tighten Rules on Excess Employee Remuneration

Section 162(m) disallows a deduction for compensation paid by publicly held corporations in excess of \$1 million to certain covered employees. Covered employees consist of the chief executive officer, the chief financial officer and the three highest-paid officers in addition to the two identified positions. For taxable years beginning after December 31, 2026, the term "covered employee" is expanded to include any employee who was among the five highest-paid employees of the corporation but who is not already included in either of the previous categories. Subject to certain exceptions and the \$1 million allowance, the disallowance applies to "applicable employee remuneration" paid to the covered employees.

The proposal would expand the scope of the disallowance provisions in four ways:

- ▶ Accelerate the effective date of the expanded definition of covered employees so that it applies three years earlier, that is, to taxable years beginning after December 31, 2023.
- ▶ Treat all members of a controlled group (as generally defined for certain employee benefit purposes) as a single employer for purposes of identifying the covered employees and applying the \$1 million deduction limitation.
- ▶ Extend the application of Section 162(m) disallowance to all amounts paid to a covered employee, otherwise treated as applicable employee remuneration, whether or not paid directly by the publicly held corporation.
- ▶ Expand the regulatory authority of the Secretary of the Treasury to carry out the purposes of Section 162(m) and to prevent avoidance of the rule.

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

Prevent Prison Facility Rent Payments from Contributing to Qualification as a REIT

A real estate investment trust (REIT) is a modified pass-through entity whose status as such is achieved by permitting a deduction for dividends paid to its shareholders. To qualify as a REIT, in addition to several other strict requirements, a REIT must meet two separate income tests. In general, at least 95% of its gross income for the year must be derived from sources on one list, while at least 75% of its gross income for the year must be derived from sources on a second list. The second list is generally narrower than the first list.

The proposal is intended to further the purposes of a January 26, 2021, Executive Order that forbade the U.S. Department of Justice from entering into any new or renewed contracts with privately operated criminal detention facilities. To prevent the tax benefits of REIT status from being available for rents received from a prison or other detention facility, the proposal would exclude from both the 95% and the 75% income tests any of such rents. Even though the Executive Order applies only to federal facilities, the tax proposal would apply to non-federal facilities as well.

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

PARTNERSHIP TAX PROVISIONS

Prevent Basis Shifting by Related Parties Through Partnerships

Under current rules, a partnership is permitted to make an election to step up the basis of partnership assets upon certain transfers of partnership interests or distributions of property to existing partners. With respect to basis adjustments created upon distributions of property, it is possible for related parties to achieve tax savings without a meaningful change in the partners' economic arrangement. This benefit is obtained by effectively shifting basis from non-depreciable, non-amortizable property to depreciable or amortizable partnership property.

For example, if Partner A has a tax basis in his or her partnership interest of \$100 and receives a distribution of property that has a tax basis of \$150, Partner A will be required to take a basis in the distributed asset equal to \$100. Additionally, the partnership will be able to record a tax basis step-up of \$50 for the remaining partnership property. This \$50 tax basis step-up will generate depreciation or amortization deductions allocable to all the partners. Importantly, Partner A will not recognize taxable gain until the distributed property is sold in a taxable transaction. Consequently, absent a disposition of the distributed property, the basis step-up rules have resulted in the creation of \$50 of deductions without recognition of gain.

The administration proposes limiting the ability of related parties to use a partnership to shift partnership basis amongst themselves. In the case of a distribution of partnership property that results in a tax basis step-up to remaining partnership assets, the proposal would apply a matching rule that would prohibit any partner that is related to the distributee-partner from benefitting from the tax basis step-up until the distributee-partner disposes of the distributed property in a fully taxable transaction.

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

Tax Carried (Profits) Interests as Ordinary Income

Following enactment of the Tax Cuts and Jobs Act in 2017, allocations of long-term capital gain representing so-called "carried interests" have been subject to recharacterization based on the holding period of property generating the gain. To the extent the property generating gain was held for three years or less, the carried interest allocations would be recharacterized as short-term capital gain subject to ordinary income tax rates.

Consistent with the administration's fiscal year 2023 budget proposal, the administration proposes treating certain carried interest allocations as ordinary. Specifically, under the proposal, a partner's share of income from an "investment services partnership interest" (ISPI) would be taxed as ordinary income, provided the partner's taxable income from all sources exceeds \$400,000. Additionally, to the extent income allocated with respect to an ISPI is taxed as ordinary income, the income would also be subject to self-employment taxation.

For purposes of these rules, 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 considered an investment partnership if (1) substantially all of its assets are investment-type assets such as securities, real estate, interests in partnerships, commodities, cash or cash equivalents or derivative contracts with respect to these assets; and (2) over half of the partnership's contributed capital is from partners holding the interest as an investment rather than in connection with a trade or business.

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

Repeal Deferral of Gain from Like-Kind Exchanges

Under current rules, taxpayers are able to exchange real property used in a trade or business or held for investment purposes for other real property without triggering taxable income. The administration's proposal would effectively repeal the ability to defer gain in excess of \$500,000 for each taxpayer (\$1,000,000 in the case of married taxpayers filing a joint return) per year in connection with the exchange of real property. Any gain above these thresholds would be recognized as taxable gain in the year of the transfer of real property subject to the exchange.

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

Amend the Centralized Partnership Audit Regime to Permit the Carryover of a Reduction in Tax That Exceeds a Partner's Tax Liability

Currently, when a partnership subject to the centralized partnership audit regime amends a return claiming a favorable benefit, such as a reduction in a partner's share of taxable income or an increase in allocable expense, the adjustment is "pushed out" to the affected partner. The affected partner is then required to recalculate his or her tax liability for the year of the adjustment. To the extent the adjustment results in a lower tax liability, the partner is required to claim the tax reduction as a nonrefundable tax credit in the year in which the amended partnership tax return is filed. Any unused tax credit is permanently lost.

For example, during 2023 AB Partnership amends its 2020 income tax return and reports a reduction in taxable income to Partner A of \$1,000. Partner A then recalculates her 2020 tax liability reflecting the reduction in taxable income. Assuming a 37% federal income tax rate, this adjustment will create a \$370 tax credit that Partner A may use to reduce her 2023 federal income tax liability. If Partner A calculates a calendar year 2023 pre-credit federal income tax liability of \$350, she will reduce this liability to \$0 but will then permanently lose the remaining \$20 tax credit.

To cure this inequitable result under the existing rules, the administration's proposal would change the treatment of the \$370 tax credit in the above example by treating the \$20 excess above the 2023 tax liability as an overpayment that may be refunded.

The proposal would be effective on the date of enactment.

INTERNATIONAL TAX PROPOSALS

The 2024 budget and Green Book incorporate measures originally proposed in the 2022 and 2023 Green Books, as well as the American Jobs Plan, and some new provisions that, if enacted, would significantly modify the U.S. international tax rules. An overview of the proposed changes is outlined below.

Global Intangible Low-Taxed Income (GILTI)

The administration's proposals would make several changes to the GILTI regime:

- ▶ The net deemed tangible income return (the qualified business asset investment (QBAI) exemption), would be eliminated, so that a U.S. shareholder's entire net controlled foreign corporation (CFC) tested income would be subject to U.S. tax.
- ▶ The Section 250 deduction would be reduced to 25%, generally increasing the U.S. effective rate on GILTI inclusions to 21% (assuming the U.S. corporate rate is changed to 28%).
- ▶ The global averaging method for computing the GILTI inclusion would be replaced with a jurisdiction-by-jurisdiction method. (A similar jurisdiction-by-jurisdiction method would apply to foreign branch income.) Under this method, a separate foreign tax credit (FTC) limitation would be computed for each jurisdiction, thus preventing the crediting of foreign income taxes paid to high-tax jurisdictions from reducing U.S. residual tax on income earned in lower-tax jurisdictions.
- ▶ The FTC reduction would be cut from 20% to 5%.
- ▶ Net operating losses (NOLs) would be allowed to be carried forward within a single jurisdiction.
- ▶ Excess FTCs would be allowed to be carried forward for 10 years within a single jurisdiction.
- ▶ The high-tax exception for subpart F income and the cross reference to that provision in the GILTI regulations would be repealed.
- ▶ A domestic corporation that is a member of a foreign-parented group would account for any foreign taxes paid by the foreign parent under an income inclusion rule with respect to CFC income that would otherwise be part of the domestic corporation's GILTI inclusion. This would be done in a manner consistent with the Pillar Two model rules on global minimum taxation and would apply on a jurisdiction-by-jurisdiction basis.

The reduction in the Section 250 deduction to 25% would be effective for taxable years beginning after December 31, 2022. The other changes impacting GILTI (and foreign branch income) would be effective for taxable years beginning after December 31, 2023.

Section 245A Deduction

The section 245A dividends received deduction (DRD) would be limited to dividends distributed either by CFCs or by qualified foreign corporations, which would include 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 DRD equal to 65% of the foreign-source dividends received from a qualified foreign corporation that is not a CFC if the U.S. shareholder owns at least 20% of the stock (by vote and value) of the qualified foreign corporation. If a U.S. shareholder owns less than 20% (by vote or value) of the stock of a qualified foreign corporation that is not a CFC, the U.S. shareholder would receive a DRD equal to 50% of the foreign-source dividends received. The DRD would remain unchanged for dividends received from CFCs.

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

Deductions 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 (for example, GILTI inclusion with respect to which a Section 250 deduction is permitted or dividends eligible for the Section 245A deduction). Section 904(b)(4), which disregards for purposes of the FTC limitation deductions allocable to income attributable to foreign stock other than GILTI or subpart F income inclusions, would be repealed.

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

Inversions

The administration's proposals would make the following changes to the inversion rules:

- ▶ The definition of an inversion transaction would be broadened by replacing the 80% test with a greater-than-50% test and eliminating the 60% test.
- ▶ Regardless of the level of shareholder continuity, an inversion transaction would occur 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 scope of an acquisition for purposes of Section 7874 would be expanded to include a direct or indirect acquisition of substantially all the assets constituting a trade or business of a domestic corporation, substantially all the assets of a domestic partnership, or substantially all the U.S. trade or business assets of a foreign partnership.
- ▶ A distribution of stock of a foreign corporation by a domestic corporation or a partnership that represents either substantially all the assets or substantially all 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 the assets or trade or business assets, respectively, of the distributing corporation or partnership.

The Secretary of the Treasury would be granted regulatory authority to exempt some 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.

Losses on Stock Attributable to Foreign Income Taxed at a Reduced Rate

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 would be 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.

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 that date).

Expanded Definition of Foreign Business Entity

Effective for tax years of a controlling U.S. person that begin after December 31, 2023, and to annual accounting periods of foreign business entities that end with or are within such taxable years of the controlling U.S. person, the administration's proposal would expand the definition of foreign business entity by treating any taxable unit in a foreign jurisdiction as a "foreign business entity" for purposes of Section 6038. Therefore, 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. Additionally, the annual accounting period for a taxable unit that is a branch or disregarded entity is the annual accounting period of its owner.

BEAT and UTPR

The administration's proposal would repeal the current base erosion and anti-abuse tax (BEAT) provisions and replace them with an undertaxed payments rule (UTPR), which is intended to be similar to the UTPR under the OECD Pillar Two model rules and would apply to foreign-parented multinationals operating in low-tax jurisdictions with financial reporting groups that have global annual revenue of \$850 million or more in at least two of the prior four years. The proposal includes several de minimis exclusions that could apply to a financial reporting group. Additionally, when another jurisdiction adopts a UTPR, a domestic minimum top-up tax would be applied in an attempt to protect U.S. revenues from the imposition of a UTPR by other countries.

Under the proposed UTPR, domestic corporations that are part of a foreign-parented multinational group, as well as domestic branches of foreign corporations, would be disallowed U.S. 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). However, the UTPR would not apply to income subject to an income inclusion rule that is consistent with the Pillar Two Model Rules, which would include income that is subject to GILTI (as proposed).

The UTPR generally would not apply to U.S.-parented multinationals. Specifically, domestic group members would be disallowed U.S. tax deductions to the extent necessary to collect the hypothetical amount of top-up tax required for the financial reporting group to pay an effective tax rate of at least 15% in each foreign jurisdiction in which the group has profits.

The amount of the top-up tax would be determined based on a jurisdiction-by-jurisdiction computation of the group's profit and effective tax rate, with certain specified adjustments and consistent with the Pillar Two model rules, which would take into account all income taxes, including the corporate alternative minimum tax. Additionally, the computation of a group's profit for a jurisdiction would be reduced by 5% of the book value of tangible assets and payroll with respect to the jurisdiction. 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.

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

Repeal of Foreign-Derived Intangible Income

The Section 250 deduction allowable to domestic corporations on their FDII would be repealed. The repeal would be effective for taxable years beginning after December 31, 2023.

Allocation of Subpart F Income and GILTI Between Seller and Buyer of CFC Stock

Section 951(a)(2)(B) reduces a U.S. shareholder's pro rata share of subpart F income and tested income when a dividend was paid to the shareholder's predecessor during the year of sale. The dividend may be eligible for the section 245A DRD if received by a corporate U.S. shareholder. As a result, only a portion of the CFC's subpart F income or tested income attributable to a share of stock would be included in income even if the share was owned by U.S. shareholders for the entire year. Regulations under Section 245A deny the section 245A DRD with respect to the dividend when a U.S. shareholder owns more than 50% of the stock of the CFC. However, the Section 245A regulations do not address all cases, such as when the dividend is received by a non-controlling shareholder.

The administration's 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 day during the year the corporation was a CFC (relevant date), 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 DRD, 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 would be allocated to a U.S. shareholder that owns a share of stock of the CFC on the last relevant day.

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 proposal would apply to taxable years of foreign corporation 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.

Calculation of CFC E&P

Under current law, in calculating current-year E&P, a CFC does not take into account three special accounting concepts - LIFO, installment sales and the completed contract method of accounting. However, for purposes of subpart F (Section 952(c)(3)), a CFC takes into account these special accounting concept. Thus, a CFC's current year E&P is generally lower for subpart F purposes than it is for other purposes. Under the administration's proposal, the E&P of a CFC would be determined for all purposes by taking into account LIFO, installment sales and the completed contract method of accounting.

The provision would be effective for taxable years of foreign corporations ending on or after December 31, 2023, and for taxable years of U.S. shareholders in which or with which such taxable years of the foreign corporations end.

Limitation of FTC from Sales of Hybrid Entities

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 FTC rules to the seller. Under this rule, any gain recognized by the seller is treated as gain from the sale of the stock of the target for purposes of applying the FTC rules.

The administration's 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 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 (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 FTC 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 on the sale or exchange of stock (determined without regard to Section 1248).

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

Restrict Deductions of Excessive Interest of Members of Financial Reporting Groups

Effective for taxable years beginning after December 31, 2023, the administration has proposed that a deduction for interest expense of a member of a financial reporting group (defined below) 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. A member's proportionate share of the financial reporting group's net interest expense would be based on the member's proportionate share of the group's earnings reflected in the financial reporting group's consolidated financial statements. A financial reporting group is a multinational group that prepares consolidated financial statements in accordance with U.S. GAAP, IFRS, or other method identified by the Secretary under regulations.

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 10% of the member's adjusted taxable income (as defined under Section 163(j)).

Disallowed interest would be carried forward indefinitely. Excess limitation would be carried forward for three years. Section 163(j) would continue to apply.

The proposed rules would not apply to financial services entities or 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.

Payments Substituting for Partnership Effectively Connected Income (ECI) Treated as U.S.-Source Dividends

Effective for taxable years starting after December 31, 2023, the administration has proposed treating 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 or her delegates 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.

Retroactive Qualified Electing Fund (QEF) Elections

Section 1295(b)(2) would be modified to permit a QEF election by the taxpayer as allowed by the underlying regulations. Taxpayers would be eligible to make a retroactive QEF election without requesting consent as long as it does not prejudice the U.S. government. The Treasury is also given authority to allow a retroactive QEF election for partnerships or other non-individual taxpayers in certain circumstances.

This 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 of Taxation of Fossil Fuel Income

The exemption from tested income for foreign oil and gas extraction income (FOGEI) of a CFC would be repealed. Moreover, the definition of FOGEI and foreign oil related income (presently included in tested income) would be amended to include income derived from shale oil and tar sands activity. Special rules would be provided for dual capacity taxpayers.

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

Tax Credit for Onshoring Jobs to the U.S.

Effective for expenses paid or incurred after the date of enactment, the administration's proposal would introduce a new business credit for onshoring.

The proposal, which is substantially similar to the proposal included in the administration's prior budget proposals, would provide a new general business credit equal to 10% of the eligible expenses paid or incurred in connection with onshoring a U.S. trade or business (limited to expenses associated with the relocation of the trade or business and would not include capital expenditures, costs for severance pay or other assistance to displaced workers).

Onshoring a U.S. trade or business is defined as reducing or eliminating a trade, business or line of business currently conducted outside the U.S. and starting up, expanding or otherwise moving the same trade or business to a location within the U.S., to the extent that this action results in an increase in U.S. jobs.

Tax Deduction Disallowance for Offshoring Jobs

Also effective for expenses paid or incurred after the date of enactment, the administration's proposal would include a disallowance of deductions for offshoring jobs.

Specifically, to reduce the tax benefits associated with a U.S. company moving jobs outside the U.S., the proposal would disallow deductions for expenses paid or incurred in connection with offshoring a U.S. trade or business (limited to expenses associated with the relocation of the trade or business and would not include capital expenditures, costs for severance pay or other assistance to displaced workers). Offshoring a U.S. trade or business means reducing or eliminating a trade, business, or a line of business currently conducted inside the U.S. and starting up, expanding or otherwise moving the same trade or business outside the U.S., to the extent the action results in a loss of U.S. jobs. Additionally, no deduction would be allowed against a U.S. shareholder's GILTI or subpart F income inclusions for any expenses paid or incurred in connection with moving a U.S. trade or business outside the U.S.

BDO Insights: The administration's 2024 budget and Green Book provide important details regarding the anticipated changes to the U.S. international tax landscape. It remains to be seen whether these proposed changes will be enacted as outlined or if additional changes will be made. However, multinational companies can start modeling now the impact these changes may have on their operations and tentatively planning to mitigate any anticipated impact.

INDIVIDUAL, ESTATE AND GIFT TAXES

High-net-worth individuals continue to be the focus of many of the administration's proposals in its fiscal year 2024 budget. The proposals, many of which look similar to prior budget proposals, encompass raising individual tax rates, raising capital gain and qualified dividend rates, taxing exchanges between grantors and grantor trusts, imposing restrictions on grantor retained annuity trusts and taxing dispositions of appreciated property at death. A summary of the income and transfer tax proposed changes most likely to be of interest to high-net-worth individuals follows.

Net Investment Income Tax (NIIT)

Not seen in prior budgets, the administration proposes to expand the net investment income tax (NIIT) base to ensure that all pass-through business income of high-income taxpayers is subject to either the NIIT or Self-Employment Contributions Act (SECA) tax. Under the proposal, a taxpayer would determine "potential NIIT income" by combining income in trade or businesses in which the taxpayer materially participates or that is otherwise not subject to NIIT under current law. 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 increase linearly to 100 as adjusted gross income rose from \$400,000 to \$500,000 (\$200,000 to \$250,000 for married taxpayers filing separately). These threshold amounts would not be indexed for inflation.

The administration also proposes to increase the NIIT rate and the additional Medicare tax rate by 1.2 percentage points for taxpayers with more than \$400,000 of earnings, which would bring the total tax rate from 3.8% to 5%. This threshold would be indexed for inflation.

Both proposals would be effective for taxable years beginning after December 31, **2022**.

Individual Income Tax Rate

The administration proposes increasing the top marginal individual income tax rate from 37% to 39.6%. For taxable year 2023, the rate would apply to taxable income over \$450,000 for married individuals filing jointly (\$225,000 for married individuals filing separately), \$425,000 for head of household filers and \$400,000 for single filers.

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

The proposal to increase the top marginal individual income rate merely accelerates the increase of the top individual tax rate to 39.6% that is currently scheduled to occur beginning in 2026, which is after most of the 2017 Tax Cuts and Jobs Act (TCJA) provisions are set to expire. However, this proposal also would lower the taxable income bracket subject to the top marginal income tax rate. As a result, the proposal would impose the top marginal tax rate on filers currently below the existing top marginal income tax rate of 37%. Thus, in 2023 the top marginal tax rate is 37% for joint filers with more than \$693,750 of taxable income (\$578,125 for single filers and heads of household, \$346,875 for married filing separately). By comparison, the proposed 39.6% tax rate is proposed to apply to taxable income over \$450,000 for joint filers.

Minimum Tax Liability

The administration also proposes a minimum tax of 25% on taxable income, inclusive of unrealized capital gains, for taxpayers with a net worth in excess of \$100 million. Payments of the minimum tax would be treated as a prepayment available to be credited against taxes on future realized capital gains. The minimum tax liability in subsequent years would equal 25% of (1) the taxpayer's taxable income and unrealized gains reduced by (2) the taxpayer's unrefunded, uncredited prepayments and regular tax. The tax due for the first year could be paid in nine equal annual installments. For subsequent years, the minimum tax could be paid in five equal annual installments.

The proposal also provides guidelines and limitations on how uncredited prepayments would be applied against future realized capital gains, in addition to providing a cap whereby a taxpayer would be fully phased into the minimum tax liability. As a result, the minimum tax would be fully phased in for all taxpayers with wealth greater than \$200 million.

Notably, the proposal does not require annual valuations of non-tradeable assets. Rather, non-tradeable assets would be valued using the greater of the original or adjusted cost basis, the last valuation event from investment, borrowing, or financial statement purposes, or other methods approved by the Secretary of the Treasury, increased annually by the sum of the five-year Treasury rate plus two percentage points. Taxpayers deemed to be illiquid because tradeable assets are less than 20% of their wealth may elect to include only unrealized gain in tradeable assets in the calculation of their minimum tax liability. However, the eventual realization of gains on such non-tradeable assets would be subject to a deferral charge not to exceed 10% of unrealized gains.

Estimated tax payments would not be required for the minimum tax liability.

For unmarried taxpayers, net uncredited prepayments in excess of any tax liability from gains at death would be refunded to the estate and includable in the decedent's gross estate for federal estate tax purposes. For married taxpayers, net uncredited prepayments remaining at death would be transferred to the surviving spouse.

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

Capital Gain and Qualified Dividend Income

Long-term capital gains and qualified dividend income of taxpayers with taxable income over \$1 million would be taxed at ordinary income tax rates to the extent the taxpayer's income exceeds \$1 million (\$500,000 for married individuals filing separately). The threshold would be indexed for inflation after 2024.

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

If the proposal for raising the ordinary income tax rate to 39.6% becomes law, then the maximum tax rate on capital gains would effectively be 44.6% (39.6% plus NIIT rate of 5%).

Transfers of Appreciated Property

The administration proposes to tax unrealized capital gains on transferred appreciated property upon the occurrence of certain realization events, which would include:

- ▶ Transfers of appreciated property by gift.
- ▶ Transfers of appreciated property on death.
- ▶ Transfers of property to, or distributions of property from, trusts (other than wholly revocable trusts).
- ▶ Distributions of property from a revocable grantor trust to any person other than the deemed owner or U.S. spouse of the deemed owner (other than distributions made in discharge of an obligation of the deemed owner).
- ▶ Terminations of a grantor's ability to revoke a trust – at death or during life.
- ▶ Transfers of property to, and distributions of property from, partnerships or other non-corporate entities if the transfer is a gift to the transferee.
- ▶ Recognition of gain on the unrealized appreciation of property held by trusts, partnerships or other non-corporate entities, if the property has not had a recognition event within the prior 90 years. The first recognition event under this 90-year rule would occur December 31, 2032, for property not subject to a recognition event since December 31, 1941.

The proposal allows some exclusions. Transfers by a donor or decedent to a U.S. spouse would not be a taxable event, and the surviving spouse would receive the decedent's carryover basis. The surviving spouse would recognize the gain upon disposition or death. Similarly, transfers to charity would not generate a taxable capital gain. Transfers to a split interest trust, such as a charitable remainder trust, would generate a gain with an exclusion allowed for the charity's share of the gain. Transfers of tangible personal property, such as household furnishings and personal effects (excluding collectibles), are excluded.

Once a donor has exhausted his or her lifetime gift exemption, the proposal would allow a \$5 million per donor exclusion from recognition of additional unrealized capital gain on property transferred by gift or held at death. Any unused exemption by a deceased spouse would be portable to the surviving spouse, effectively making the exclusion \$10 million per couple. This additional exclusion amount would be indexed for inflation after 2023. The transferee's basis in the property shielded by this exemption would be the fair market value of the property at the time of the gift or the decedent's death.

Payment of the tax on the appreciation of certain family-owned and -operated businesses may be deferred until the business is sold or ceases to be family-owned and -operated.

The capital gains tax on appreciated property transferred at death would be eligible for a 15-year fixed rate payment plan. However, publicly traded financial assets will not be eligible for the payment plan. Furthermore, family businesses electing the deferral will not be eligible for the payment plan.

The proposal generally would be effective for transfers by gift, and on property owned at death by decedents dying after December 31, 2023, and on property owned by trusts, partnerships and other non-corporate entities on January 1, 2024.

Contributions of appreciated property to split-interest trusts, such as charitable remainder trusts, will no longer have the favorable treatment afforded under current law – likely making that planning strategy less attractive as a deferral planning technique. Transfers to S corporations and C corporations do not appear to generate gain, assuming those transfers qualify for the deferral provisions of Section 351.

Notably, this proposal does not eliminate the \$500,000 exclusion currently available to joint filers (\$250,000 for unmarried filers) upon the sale of their principal residence, nor does the proposal eliminate the current exclusion on the sale of qualified small business stock.

This proposal radically alters the rules for recognition of income when it comes to capital assets. Under current law, there generally must be a sale or exchange of property to generate a capital gain. Because the proposal would "deem" a sale when in fact there was no sale, the taxpayer will not necessarily have the cash to pay the capital gains tax. Thus, taxpayers would need to exercise the utmost care to avoid the liquidity issues created by a "deemed" sale.

Defined Value Formula Clauses

Defined value formula clauses are generally used to avoid triggering gift tax liability, for example, by limiting the gift to the amount of property equal to the donor's remaining gift tax exclusion amount. The formula clause often determines the gift value by reference to the results of IRS enforcement activities. The administration proposes that a defined value formula clause be based on variables that do not require IRS involvement. If a formula clause references IRS involvement to determine the value of the gift (or bequest), then the gift (or bequest) will be deemed to be the value as reported on the corresponding gift or estate tax return. However, a formula clause would be effective if the value is determinable by something identifiable, other than activity of the IRS.

The proposal would apply to transfers by gift or on death occurring after December 31, 2023.

Revision of Gift Tax Annual Exclusion

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 and would impose an annual limit of \$50,000 per donor, indexed for inflation after 2024, on the donor's transfers of property within this new category that would qualify for the gift tax annual exclusion. Thus, a donor's transfers in the new category in a single year in excess of the total amount of \$50,000 would be taxable, even if the total gifts to each individual donee did not exceed \$17,000.

The new category would include transfers in trust (other than trusts designed to qualify for the generation-skipping tax annual exclusion), transfers of interest in passthrough entities, transfers of interests subject to a prohibition on sale, partial interests in property, and other transfers of property that, without regard to withdrawal, put, or other such rights in the donee, cannot immediately be liquidated by the donee.

The proposal would be effective for gifts made after December 31, 2023.

Grantor Trusts

Currently, sales between a grantor and his or her intentionally defective grantor trust are nontaxable events. The proposal would recognize such sales and require the seller to recognize gain on the sale of appreciated assets. Taxable transfers also would include the satisfaction of an obligation (i.e., annuity or unitrust payments) with appreciated property. The provision would apply to all transactions between a grantor trust and its deemed owner occurring on or after the date of enactment.

The proposal also would treat the payment of a grantor trust's income taxes by the deemed owner as a taxable gift occurring on December 31 of the year in which the tax is paid, except to the extent the deemed owner is reimbursed by the trust during that same year. The provision would apply to all trusts created on or after the date of enactment.

BDO Insight: This proposal would overturn the IRS's prior ruling in Rev. Rul. 85-13, which disregarded transactions between a grantor and his or her grantor trust for income tax purposes.

Grantor Retained Annuity Trusts (GRATs)

Grantor retained annuity trusts (GRATs) currently do not have term restrictions or remainder interest restrictions. The proposal, however, would require a minimum term of 10 years and a maximum term equal to the annuitant's life expectancy plus 10 years for all GRATs.

In addition, a GRAT's remainder interest would be required to have a minimum value (for gift tax purposes) equal to the greater of (1) 25% of the value of the assets transferred to the GRAT or (2) \$500,000 (but not more than the value of the assets transferred). The GRAT annuity may not decrease during the GRAT's term. Further, the grantor would not be allowed to engage in tax-free exchanges of assets held in the GRAT.

The provisions would apply to all trusts created on or after the date of enactment.

BDO Insights: This provision would effectively eliminate short-term GRATs that are commonly used in a rolling GRAT strategy to reduce the risk of a grantor dying during the GRAT term (and thereby result in the inclusion of the GRAT's assets in the grantor's estate). This provision also would prohibit the use of zeroed-out GRATs.

Generation-Skipping Transfer (GST) Tax Exemption

The administration proposes to limit the benefit of the generation-skipping transfer (GST) tax exemption to certain generations. GST tax exemption would apply only to direct skips and taxable distributions to beneficiaries who are no more than two generations below the donor, and to younger-generation beneficiaries who were alive when the trust was created. Also, GST tax exemption would apply only to taxable terminations that occur while any of the aforementioned persons are beneficiaries of the trust.

These proposals would apply on and after the date of enactment to all trusts subject to the GST tax, regardless of the trust's inclusion ratio. For purposes of determining beneficiaries who were alive when the trust was created, trusts created prior to the date of enactment would be deemed to have been created on the date of enactment. Further, decanted trusts and pour-over trusts would be deemed to have been created on the same date of creation as the initial trust.

BDO Insight: This proposal eliminates the ability to shield trust assets from GST tax in perpetuity, dramatically reducing the allure of dynasty trusts as a tax-saving tool.

Intrafamily Loans

Generally, an intrafamily note carries an interest rate equal to the applicable federal rate (AFR), which has been historically low, to ensure the loan is not treated as a below-market loan or a gift. After the note holder's death, the valuation of the note for estate tax purposes often includes a discount because the note's interest rate is well below the market rate.

The administration proposes to remedy this inconsistency in valuation by limiting the discount rate to the greater of the note's actual interest rate or the AFR for the remaining term of the note on the note holder's date of death. The note would be treated as a short-term note or valued as a demand loan if there is a reasonable likelihood that the note will be satisfied sooner than the specified payment date. The proposal would apply to valuations as of a valuation date on or after the date of enactment.

This proposal would seemingly align the valuation of notes for both income and estate tax purposes.

Valuation and Intrafamily Transfers

Taxpayers regularly transfer marketable securities and other liquid assets to partnerships or other entities, make intrafamily transfers of interests in those entities and then claim entity-level discounts in valuing the gifts. Similarly, intrafamily transfers of partial interests in other hard-to-value assets such as real estate, art or intangibles also occur, allowing all family co-owners to claim fractional interest discounts. The proposal would minimize or eliminate valuation discounts for lack of marketability and lack of control for intrafamily transfers of partial interests in property in which the family collectively has an interest of at least 25% of the whole.

The value of the partial interest transferred would be the interest's pro-rata share of the collective fair market value of all interest in that property held by the transferor and the transferor's family members, with that collective fair market value being determined as if held by a sole individual.

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

Other Proposals

The following may also impact high-net-worth taxpayers:

- ▶ The special use valuation limit for estate tax purposes for qualified real property would increase to \$13 million.
- ▶ Trusts would have to report estimated value of trust assets and other information on an annual basis.
- ▶ A trust's exemption from generation-skipping tax would be impacted when the trust engages in transactions with other trusts, such as a sale or decanting.
- ▶ A charitable lead annuity trust would be required to fix the annuity paid to charity as a level fixed amount over the term of the charitable lead annuity trust. The remainder interest in a charitable lead annuity trust would have to be at least 10%.
- ▶ Loans from a trust to a trust beneficiary would be treated as a distribution. These loans can impact generation-skipping tax, especially if a loan is made to the grantor.

Incorporate Chapters 2 and 2a in Centralized Partnership Audit Regime Proceedings

The centralized partnership audit regime currently applies to Chapter 1 income tax matters but excludes self-employment and net investment income taxes under Chapters 2 and 2A. As a result of the current rules, audits of partnerships can be cumbersome and less efficient than intended when income, self-employment and net investment income tax matters are applicable. Additionally, the disconnect between these taxes places a significant burden on partners who must separately address self-employment and net investment income tax consequences resulting from changes to partnership-level income items.

To create greater administrative efficiencies and ease burdens on affected partners, the administration's proposal would modify the centralized partnership audit regime to include items affecting a partner's self-employment and net investment income tax liabilities 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 tax years.

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% 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.

The administration's proposal would repeal the exemption from the corporate income tax for publicly traded partnerships with qualifying income and gains from activities relating to fossil fuels.

The proposal would be effective for taxable years beginning after December 31, 2028.

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