FY2023 Green Book Options

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Introduction

This Memo includes selected policy options to consider for the FY2023 Green Book. As outlined below, this Memo's scope is limited, but we would welcome the opportunity to provide input beyond the stated scope. This Memo:

- Assumes that the Build Back Better Act as passed by the House is enacted into law;
- Does not address some of the policy decisions with the most significant revenue and policy impact for this Green Book, including: (a) adjustments to tax rates (such as the corporate tax rate) or thresholds (such as for the AGI surtax) after the Build Back Better Act, (b) the preferred option for addressing unrealized gains, (c) extending or making permanent various expiring provisions in the law, or (d) overall revenue goals. We are happy to provide separate input on such issues;
- Does not generally address proposals in the FY2022 Green Book not enacted into law (for example, paid preparer regulation, repealing fossil fuel subsidies, carried interest, etc.) that we assume will be carried over. We are happy to provide input into any discussions about changes to FY2022 Green Book proposals;
- Does not address key tax administrative law issues facing the Administration (such as OIRA review of certain tax regulations and responses to *CIC Services*), though we are, again, happy to discuss decisions that will determine regulatory capacity generally;
- Does not focus on specific proposals where there is likely a choice between a legislative and a regulatory option, but we have given significant thought to such proposals and the choice of route, and are happy to discuss; and
- Is by no means exhaustive and focuses on areas in which we have recently been engaged, though we have capacity to go beyond these areas. This list of options also (a) accounts for the Administration's already-determined objectives of avoiding tax increases on

"small businesses" and individuals making under $400,000; and (b) prioritizes proposals that are drafted or may be relatively easy to draft within this current budget cycle.

Given timing, we are also sharing this Memo widely. As a result, this Memo may be simultaneously too detailed and not comprehensive enough for different readers. We are happy to go into more technical detail on drafting and scoring issues in areas where our staff have deep expertise, or to discuss broader policy considerations as desired.

Corporate

Conform corporate ownership standards

Law: There are multiple standards of corporate ownership used in subchapter C and throughout the Code. For some purposes (e.g., tax-free organizations), the relevant ownership threshold is defined in section 368(c) as the ownership of 80% of the voting stock and 80% of the number of shares of all other classes of stock of the corporation. For other purposes (e.g., consolidated returns, tax-free liquidations), the relevant ownership threshold is defined in section 1504(a) as the ownership of at least 80% of the total voting power and at least 80% of the total value of the corporation's stock.

Problem: The ability to allocate voting power among the shares of a corporation along with the absence of a value component in section 368(c) creates opportunities for inappropriate planning. In addition, the inconsistent ownership thresholds result in significant complexity.

Proposal: Conform section 368(c) with section 1504(a) so that section 368(c) also requires at least 80% of the voting power and at least 80% of the total value of a corporation's stock. Most recently, this proposal was included in the FY2017 Green Book. The Joint Committee on Taxation (JCT) analysis of this proposal is included in its description of the FY2015 Green Book.

Revenue: $217M from 2016-2026 (per JCT, as scored in pre-TCJA context).[1]

Repeal non-qualified preferred stock (NQPS) designation

Law: NQPS is preferred stock with certain debt-like features. Since 1997, NQPS has been treated as taxable "boot" for some purposes and stock for other purposes. The NQPS provisions were enacted in response to concerns that certain types of preferred stock used in tax-free transactions more closely resemble taxable consideration.

Problem: The hybrid treatment of NQPS has made it a staple of affirmative corporate tax planning. In addition, the NQPS provisions add complexity to the Code.

Proposal: Repeal the provisions that treat NQPS as boot and all cross-referencing provisions (e.g., sections 354(a)(2)(C), 355(a)(3)(D), and 356(e)). Most recently, this proposal was included in the FY2017 Green Book. The JCT analysis of this proposal is included in its description of the FY2013 Green Book.

[1] Where possible, we refer to previous revenue estimates for relevant proposals. Many of these were estimated against a different baseline and care should be taken to adjust accordingly when interpreting older estimates.

Revenue: $146M from 2016-2026 (per JCT, as scored in pre-TCJA context). $430M from 2017-2026 (per the Office of Tax Analysis (OTA)).

International

As noted above, we focused on proposals not in the prior Green Books or the Build Back Better Act as we assume there will be a full process to determine whether to carry forward those proposals in areas where (a) a less robust proposal was enacted; and/or (b) no proposal in the space was enacted. We are happy to provide input. We also note that because the Build Back Better Act was silent on anti-inversion rules, the sound anti-inversion proposals in the FY2022 Green Book may be particularly attractive to carry forward.

Further, there are a particularly large number of international tax issues that could be addressed potentially either through regulation or legislation. This memo does not generally discuss those issues because of the many considerations including regulatory authority and regulatory capacity. This is an area that we are generally giving substantial attention and are happy to discuss further both regulatory and legislative routes to address issues such as: nimble dividends and/or other issues relating to section 245A; the scope of section 961(c) (including the changes thereto proposed in section 138129(c)(5) of H.R. 5376 as introduced on September 27, 2021 (the September 27 Ways and Means draft)); consistency of elections among members of a group of foreign corporations under section 957(a)(2); and very many other possibilities. In some cases, addressing these issues would raise revenue, while in others there may be a revenue cost.

Additional options in the international space include:

Apply the base erosion anti-abuse tax (BEAT) in the case of section 59(e) elections

Law: The amount of the BEAT imposed under section 59A is determined based on base erosion tax benefits with respect to base erosion payments. Under current law, base erosion payments include certain payments to foreign related parties if they are deductible or are for property that gives rise to depreciation or amortization deductions. The Build Back Better Act would take into account, in determining the base for the BEAT, cost of goods sold and certain other payments to a foreign related party that are capitalized into inventory or required to be capitalized under section 263A.

Problem: Although the requirement for capitalization under section 263A does not apply to certain payments, under section 59(e), a taxpayer can make an election to capitalize certain such payments and deduct them over 10 years. A section 59(e) election could therefore transform payments to a foreign related party that would be base erosion payments giving rise to a base erosion benefit into payments that do not give rise to base erosion benefits.

Proposal: Expand section 59A(c)(2)(B) and (d)(2)(B), as revised by the Build Back Better Act, to treat amounts subject to a section 59(e) election as base erosion payments giving rise to a base erosion benefit.

Revenue: Expected to raise revenue, but the amount is unclear.

Prevent manipulation of the deduction for foreign-derived intangible income (FDII) through income acceleration

Law: Under current law, the amount of a domestic corporation's FDII for a taxable year for purposes of the section 250 deduction equals the product of its deemed intangible income for the year and the ratio of its foreign-derived deduction eligible income (FDDEI) to its deduction eligible income (DEI) for the year (the foreign-derived ratio).

Problem: Assuming a certain amount of FDDEI and DEI over a period of multiple years, taxpayers can increase their amount of FDII by causing the FDDEI to be accrued in a single year.[2] Suppose, for example, that a domestic corporation, DC, expects to earn $100x of DEI for each of the next 5 years, and that $50x in each year is expected to be FDDEI from sales to a foreign related party for on-sale to foreign unrelated parties. On that basis, the foreign-derived ratio would be 50% for each year. If, however, DC accelerates its FDDEI of $200x into the first year of the period by contracting with the related party for pre-payment for the remaining years, the foreign-derived ratio would be 80%, and DC's FDII (and thus, section 250 deduction) would be much higher.

Proposal: If the section 250 deduction for FDII is not eliminated, revise section 250 to prevent manipulation through income "bunching." This could be done by disregarding, for FDII computation purposes only, amounts that are received or accrued in advance of the period to which they are attributable. The disallowance could be limited only to amounts accelerated with a principal purpose of increasing a FDII deduction or from a related party. (Consideration could also be given to whether there is sufficient authority for Treasury and IRS to adopt this proposal through regulatory action under the broad regulatory authority of current section 250(c).)

Revenue: Expected to raise revenue, but the amount is unclear. A reported recent surge in tax benefits (over $3B from year-to-year) could potentially be attributable, in part, to income "bunching" and suggest significant revenue from disregarding income acceleration for FDII purposes.

Define cash as a passive asset for purposes of the passive foreign investment company (PFIC) rules

Law: A foreign corporation is a PFIC if the average percentage of assets held by the corporation during the taxable year that produce passive income or that are held for the production of passive income (passive assets) is at least 50 percent. Longstanding guidance and proposed regulations indicate that, subject to a narrow exception in the proposed regulations, cash is a *de jure* passive asset.

Problem: Taxpayers may take the position that cash held for potential investment in activities that would generate non-passive income is not a passive asset, notwithstanding the guidance, and that the regulations, if finalized, are invalid. The government can and presumably will contest any such argument.

[2] In fact, practitioners have highlighted that, "'[l]umpy FDDEI' can increase aggregate FDII." (See slide 15.)

Proposal: Amend the PFIC rules to confirm that cash is a passive asset, potentially subject to a working capital exception.

Revenue: Expected to raise revenue, but the amount is unclear. We are also uncertain how OTA or JCT might account for the existence of proposed regulations. Note, however, the recent considerable press about special purpose acquisition companies, which are often foreign corporations, and the considerable amounts of cash they hold in anticipation of an acquisition.

Tax Administration

Implement reciprocal reporting under the Foreign Account Tax Compliance Act (FATCA)

Law: FATCA generally requires foreign financial institutions, in order to avoid the imposition of a US withholding tax, to report to the IRS comprehensive information about certain US accounts. For example, FATCA requires foreign financial institutions to report account balances, as well as amounts such as dividends, interest, and gross proceeds paid or credited to a US account without regard to the source of such payments.

Problem: As discussed in the FY2017 Green Book, the US 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 successful IRS enforcement efforts against offshore tax evasion. The strength of those information exchange relationships depends, however, on cooperation and reciprocity. Currently, financial institutions in the US are not required to report to the IRS certain information that is required to be exchanged by the IRS and thus such information cannot be obtained or exchanged, as required.[3] While the Corporate Transparency Act (CTA) takes important steps towards anti-corruption goals, it is not structured to satisfy our existing information exchange obligations under the Reciprocal Model 1 intergovernmental agreements (IGAs) that are often used to implement FATCA. There are various reasons for this, including the fact that the Model 1 IGAs contemplate information exchange obligations related to financial accounts of a certain subset of foreign account holders, whereas the CTA provides for just beneficial ownership information with regard to a different subset of entity owners.

Proposal: As proposed in the FY2017 Green Book, requiring financial institutions in the US to report to the IRS the comprehensive information required under FATCA with respect to accounts held by certain foreign persons, or by certain passive entities with substantial foreign owners,

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[3] See, e.g., Staff of the Joint Committee on Taxation, JCX-49-21, Present Law and Background on the Federal Taxation of Domestic Trusts, p. 20 et seq. (2021). ("The inability to comply with requests for information about foreign persons believed to have an interest in financial accounts maintained in the United States stems from the fact that State law controls the formation of legal entities and the record keeping required of those entities. Although banks are required to exercise due diligence (i.e., "know your customer" rules) when opening an account, that does not necessarily result in maintenance of adequate information to identify all ultimate owners. No uniform system of determining the identity of owners of an interest in a U.S. entity is available to the Federal authorities, impairing enforcement of U.S. tax law as well as precluding reciprocity in exchanges of information with the many countries that do maintain such information at the national level.")

would facilitate the intergovernmental cooperation contemplated by the IGAs by enabling 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, the proposal could also require financial institutions reporting information to the IRS under FATCA to provide a copy of such information to the account holder in order to promote transparency and increase voluntary tax compliance.

This proposal was part of President Obama's strategy to combat illicit financial activity and tax evasion, and it would further President Biden's strategy on countering corruption.[4] While the CTA takes some important steps on beneficial ownership reporting, it was not developed to ensure the ability of the US to meet its information exchange obligations.

Revenue: Uncertain. The FY2017 Green Book scored this provision as having no revenue effect. However, there may be indirect revenue effects associated with maintaining and improving bilateral information exchange partnerships.

Adopt financial account reporting requirements

Improved information reporting remains crucial to ensure that restored IRS funding is used most effectively and efficiently. The various information reporting proposals proposed and discussed since the FY2022 Green Book have been a major area of the Tax Law Center's work, and we would be happy to discuss options in further detail as you consider proposals in this space.[5]

Strengthen penalties

There are various proposals to increase underpayment penalties for high-net-worth or high-income taxpayers.[6] These proposals could be considered in the development of the Green Book, as they can improve voluntary compliance and equity and build on the Administration's tax compliance agenda, while reinforcing the compliance focus on the most egregious and high-return on investment forms of tax avoidance and evasion.

Penalties options may also be consistent with the President's strategy on countering corruption. For example, under Objective 2.1, it is contemplated that "Treasury will issue regulations that will include reporting requirements for those with valuable information regarding real estate transactions." If this reporting includes tax reporting, appropriate penalty enhancements should be considered.

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[4] Objective 1.2 calls for departments and agencies to promote information sharing internally as appropriate, including with governmental partners, in order to curb illicit finance, hold corrupt actors accountable, and bolster international partnerships.

[5] While this document generally excludes items that were included in the FY2022 Green Book, we have included this recommendation as there have been substantial discussions about potential alterations or alternatives to this proposal.

[6] See, e.g., the amendments to sections 6662(a) in the Restoring the IRS Act and the Stop CHEATERS Act.

Improve the Corporate Transparency Act

Problem: The Administration has stated priorities of (a) combating tax evasion and non-compliance among wealthy filers and businesses; and (b) combating corruption. These priorities are closely linked.

Currently, the IRS does not have efficient and effective tools to identify the ultimate beneficiaries of substantial assets held in and income flowing through complex tiered structures, including those that use trusts, partnerships, and other pass-through entities.

If not addressed, this lack will hamper the Administration's ability to achieve its tax compliance and anti-corruption goals. While the database of beneficial ownership required by the CTA has potential to fill that need, it does not currently cover trusts, partnerships, or other entities that have no state law filing requirement. This hole is not a marginal issue. As seen previously in tax enforcement, the activities that are most corrosive to tax compliance and the rule of law are likely to flow over time towards these entities. The South Dakota trusts that are a focus of the Pandora Papers do not have a filing requirement at creation, and will become more attractive, not less, as a means to shield assets from tax and other regulatory authorities. Trusts formed elsewhere and later brought onshore could also avoid reporting requirements. States may also alter their rules for forming other entities to circumvent the CTA.

Some of these inadequacies flow directly from the CTA and so FinCEN cannot fix them with regulation. The statute was the product of a highly negotiated process under the Trump Administration. Although FinCEN cannot fix all of these statutory flaws, the Administration should pursue legislation to do so. Compared to the Trump Administration, the Biden Administration has far different tax and anti-corruption priorities, faces a different Congress, and also faces the Pandora Papers stories that draw attention to some of the CTA's largest inadequacies, including with regard to South Dakota trusts and other entities without a filing requirement at formation. Domestic and international attention to the Pandora Papers is likely to intensify, especially multilaterally, because the initial revelations came during a period when relevant multilateral counterparts were absorbed almost fully in the intense activity around the OECD BEPS project.

Furthermore, in our initial review of the proposed FinCEN rule, the database may have limited usefulness for IRS tax compliance efforts. For example, the current proposed rule does not require (although it does allow) reporting of taxpayer identification numbers (TINs) for beneficial owners, which could cause a major practical barrier to the IRS's ability to use the database efficiently.[7] If the Administration does not ultimately fully use its statutory authority in

[7] The statute is silent on whether TINs should be tied to beneficial owners. Proposed 31 CFR § 1010.380(b)(2) would allow reporting companies to disclose the TINs of its beneficial owners and company applicants on a solely voluntary basis. The preamble to the proposed rule discusses the extensive law enforcement benefits of being able to link TINs to beneficial ownership information. Voluntary disclosure of beneficial owners' TINs does not guarantee compliance. Inability to link TINs to beneficial owners will undermine tax compliance for the purposes of the CTA. If the final regulations (potentially under authority in 31 USC § 5336(b)(4)(A)) do not require disclosure of beneficial owners' TINs, then legislation should be pursued to require this.

this and other areas, or takes the position that this authority is too constrained, then it should pursue statutory options to address these holes.

Proposal: There are two broad legislative strategies available.

The first is to amend the CTA or otherwise legislate to (a) cover some of the most worrisome entities currently left out (certain trusts and partnerships), and (b) ensure the CTA database is structured to link to TINs and modes of access so that it has practical utility for the IRS. Changes like these are consistent with international best practice that generally apply to all legal entities or associations. The US's current failure has recently been noted by the EU. The appropriate route for these improvements may not be a Green Book proposal, but should involve substantial Treasury tax input.

The second is to pursue a parallel track (e.g., through reciprocal FATCA) to ensure the IRS has the ability to identify ultimate beneficial ownership of complex webs of entities. This would likely mean some duplication in reporting (as occurs today under the overlapping Foreign Bank and Financial Accounts (FBAR) and Form 8938 requirements). Duplicative reporting is suboptimal – but superior to the IRS not having adequate tools to efficiently identify beneficial ownership and to satisfy its existing information exchange obligations with partner jurisdictions and to satisfy its existing information exchange obligations with partner jurisdictions.

We are happy to further discuss detailed options within each of these tracks. In particular, we have given consideration to:

- Ways to bring into the CTA trusts, partnerships, and other entities where there is no state filing requirement at creation, while taking into account the desire to ensure that entity creators can be put on notice about the need to comply through some interaction with a state or federal authority.
- Ways to ensure that the database is useful in practice for the IRS, including by requiring the listing of TINs for both reporting companies and owners.
- Grouping and attribution rules to prevent avoidance.

Strengthen the Whistleblower Program

Law: Under section 7623, a person who provides original information about a company's or another person's underpayment of taxes to the IRS can receive 15-30% of the revenue recovered because of that information. Since 2007, the IRS Tax Whistleblower Program has recovered more than $6 billion from noncompliant taxpayers.

Problem: In 2020, the National Whistleblower Center (NWC) outlined several reforms that were needed to strengthen and improve the program in order to encourage even more whistleblowers to come forward.

Proposal: There are multiple approaches to consider. The NWC and other have endorsed the Grassley-Wyden IRS Whistleblower Program Improvement Act of 2021, which would:

- Provide whistleblowers with *de novo* review during appeals;
- Exempt whistleblower awards from budget sequestration;

- Offer whistleblowers presumption of anonymity in Tax Court;
- Require the IRS to pay interest on whistleblower awards delayed by more than 1 year; and
- Create a dedicated funding stream for the Whistleblower Program.

Revenue: Not yet estimated, likely small.

Adopt uncertain tax position (UTP) reporting requirement for pass-through entities

Law: Schedule UTP is a form that certain corporations are required to use to report federal income tax positions for which the corporation or a related party has either (a) recorded a reserve for federal income tax in audited financial statements, or (b) not recorded a reserve because the corporation expects to litigate the position. Pass-through entities are not required to file a Schedule UTP or an equivalent.

Problem: There is substantial non-compliance with federal income tax law among partnerships and other pass-through entities.

Proposal: A requirement similar to Schedule UTP can be applied to certain partnerships to help better target partnership (and, potentially, S corporation) audits. This would require a grant of authority that allows the IRS to develop different rules than for current Schedule UTP, because Schedule UTP relies on financial accounting rules that do not generally apply to pass-throughs.

Revenue: Not yet estimated, likely small, though restored IRS funding may improve chances of a non-negligible score.

Transfer Tax

The recommendations in this section would generally complement any proposal to address the taxation of unrealized capital gains. We are happy to discuss details of ensuring consistency with any unrealized gains proposal (as well as options for addressing the taxation of unrealized gains more broadly).

Further, there are several recommendations in this section that are responsive to the improper tax planning and abuses raised in the Pandora Papers. The Pandora Papers primarily highlight that the US has become a desired tax and secrecy haven for foreigners, but it is important to note that this is a direct byproduct of the ways in which wealthy US residents have used (and sometimes shaped) various federal and state transfer tax and other laws. The following options would both halt the erosion of the federal transfer tax base and lessen the appeal of the US as a tax and secrecy haven for foreigners: (a) information reporting for trusts, (b) limiting the duration of generation-skipping transfer tax exemption for dynasty trusts, and (c) imposing a Form 3520 filing requirement for off-shore trusts that are brought on-shore.

Reform grantor trusts

Law: The income tax rules for determining the deemed owner of trust property for income tax purposes are substantially different from the transfer tax rules that determine the owner of a trust for purposes of the estate, gift, and generation-skipping transfer tax. See sections 671-679; 2036-

2038, 2511, and 2642(f). Consequently, the deemed owner of trust property for income tax purposes does not always match the deemed owner of trust property for transfer tax purposes.

Problem: Incongruity between income tax ownership and transfer tax ownership results in complexity and invites inappropriate planning. Notably, the disconnect between the income tax and transfer tax regimes has given rise to two common trust structures designed to avoid at least one level of federal taxation: intentionally defective grantor trusts (IDGTs) and incomplete gift nongrantor trusts (INGs).

IDGTs enable the deemed income tax owner of the trust to achieve two advantages that are used in much of transfer tax planning for high-net-worth individuals: (a) the grantor essentially makes tax-free gifts to the IDGTs by paying the income tax attributable to the trusts' taxable income, and (b) the grantor avoids the realization of income and recognition of gain or loss with respect to transactions between the grantor and their grantor trusts. Sale transactions between deemed owners and their grantor trusts often "freeze" the value of an asset in their estate and remove most of the future appreciation from the transfer tax base.

INGs enable taxpayers to avoid/defer state income taxes and spread qualified small business stock benefits among multiple nongrantor trusts without incurring any gift tax consequences.

Proposals:

Option A – Estate Tax Inclusion for Grantor Trusts and Income Tax Realization for Transactions Between Deemed Owner and the Grantor Trust

This set of proposed changes can be found in sections 2901 and 1062 as proposed to be added by section 138209 of the September 27 Ways and Means draft.

This proposal treats transfers to grantor trusts as transfers subject to estate tax on the deemed owner's death and subject to gift tax when the deemed owner ceases to own the trust assets for income tax purposes. Essentially, if a taxpayer owns trust assets for income tax purposes, they would also own those trust assets for gift and estate tax purposes (regardless of whether the trust may have previously been considered a completed gift trust).

Arguably, this proposal confuses existing transfer tax rules by layering on income tax concepts. As a result, this proposal has not been endorsed by American College of Trust and Estate Counsel (ACTEC). However, because inappropriate planning results from a mismatch between income tax rules and transfer tax rules, this proposal would be an effective way to cut down on the use of IDGTs in transfer tax planning. In other words, even if the drafting and Code structure of this option may be less elegant than Options B and C (discussed below), few if any filers will end up using the resulting rules because the mismatch benefits will be eliminated.

Option B – Narrow Scope of Grantor Trust Rules to Minimize Inappropriate Planning

As an alternative to Option A, Professor Mark L. Ascher has proposed significantly curtailing the grantor trust rules. This proposal was endorsed by the ACTEC and would require repealing sections 673-675, 677(a)(3), and 678. In effect, grantor trust treatment would only be retained for revocable trusts, irrevocable trusts included in the grantor's estate, unit investment trusts,

retirement accounts treated as trusts for income tax purposes, and some or all trusts holding stock in S corporations. Unlike Option A, Option B would help to reduce the incongruity between income tax rules and transfer tax rules and simplify the Code.

This proposal is narrower and more precise than Option A. Unlike Option A, this proposal has support from ACTEC and the transfer tax community. This proposal would reduce the number of ways individuals can create grantor trusts but will not eliminate grantor trusts in certain business contexts. Generally, and with some exception, the result will be that if a trust is included in an individual's estate, that individual will be the deemed owner for income tax purposes.

Option C – Cure the Unintended Transfer Tax Advantages of Grantor Trusts

As an alternative to Options A and B, this proposal would *not* require significant overhaul of the grantor trust rules but would eliminate the unintended transfer tax advantages associated with grantor trusts. As discussed in more detail in Section III of the ACTEC Report on Grantor Trusts, two new rules can be adopted that generally:

- Create a federal right of reimbursement to the deemed income tax owner from the trust in the amount of any federal or state income tax paid with respect to the trust; and
- Treat transactions between a grantor and his or her grantor trust as causing recognition of income.

A right of reimbursement would arise annually when the grantor pays income tax on behalf of the trust and would lapse at the end of the calendar year in which the income tax is due. If the right of reimbursement is waived or lapses, the grantor would be treated as making a gift in the year that the tax was paid on the date of the waiver or lapse.

A rule causing recognition on transactions between the deemed income tax owner of a trust can be done by statute or through regulations even without a change to the statute. An example of legislative text for this rule can be found in section 1062 as proposed to be added by section 138209 of the September 27 Ways and Means draft.

This option does not cure the mismatch between income tax and transfer tax rules but does cure the unintended transfer tax benefits of the grantor rules. Like Option B, this proposal has also received support from ACTEC and the transfer tax community because it does not further confuse existing transfer tax definitions (like Option A). However, drafting and scoring may not be worth the effort given that it will have the same practical effect as Option A in that taxpayers will have little incentive to create IDGTs for transfer tax planning.

Revenues: Option A scored at $7.9 billion between 2022 – 2031, according to the JCT. Note that this estimate assumes a lower basic exclusion amount.

Options B and C are likely to be similar because the effect of these rules will be similar.

Increase information reporting for trusts

Law: Generally, a trust must obtain a TIN if it has $600 or more of annual income or a non-resident/non-citizen (NRNC) beneficiary.[8] While trusts must typically file an income tax return via Form 1041, this filing requirement is optional for many grantor trusts, making it difficult to track the inflow and outflow of assets in a grantor trust during the grantor's lifetime.[9] Further, section 6048 requires robust information reporting for foreign trusts created by or established for the benefit of US persons. There is currently no such reporting requirement for domestic trusts, whether created by NRNCs or US persons.

Problem: While the IRS's Statistics of Income program provides data on the income of trusts, not all trusts file income tax returns, so this information is incomplete. The lack of information reporting for trusts presents the largest income tax enforcement obstacles for domestic grantor trusts and foreign trusts that are later brought onshore. Imposing a reporting requirement across all trusts would capture: (a) non-gift transactions between grantors and their grantor trusts; (b) transactions between trusts that do not show up on any filings because the trusts share a grantor or one trust is the grantor of the other trust;[10] and (c) transactions involving newly domesticated foreign trusts that will not typically be subject to any US tax regime other than the federal income tax regime.

Proposal: The Sensible Taxation and Equity Promotion Act of 2021 includes an information reporting requirement for trusts that could be enacted independently. This proposal would require information reporting for all trusts other than (a) charitable trusts and (b) trusts subject to the reporting requirement of section 6048(b). Lawmakers could consider *not* requiring information reporting for trusts that are wholly revocable by the grantor (as such trusts are often used for legitimate non-tax purposes and the assets are fully includable in the grantor's estate). This reporting requirement would look like Form 3520 and capture trust-to-trust transactions.

Revenue: Unclear but small; more likely to generate scoreable revenue assuming IRS is adequately funded.

Limit duration of generation-skipping transfer (GST) exemption for dynasty trusts

Law: A GST tax is imposed on gifts and bequests to transferees who are two or more generations younger than the transferor. Each person has a lifetime GST tax exemption ($11.7 million in 2021) that can be allocated to transfers made, whether directly or indirectly (through a trust), by that person to a grandchild or other "skip person." A GST tax is imposed on every "taxable termination" and "taxable distribution." The rate for imposing the GST tax is the highest marginal estate tax rate multiplied by the trust's inclusion ratio. A trust that is fully

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[8] Section 6109; Treas. Reg. § 301.6109-1(a); section 6012(a)(4) and (5).
[9] *See* Christopher J.C. Jones & Caitilin N. Horne, *Grantor Trust Income Tax Reporting Requirements – A Primer*, 30 Prob. & Prop. 40 (2016). *See also* Treas. Reg. § 1.671-4.
[10] S*ee* PLR 201633021 (April 29, 2016). This PLR has paved the way for asset sales between trusts with no income tax consequences. Asset sales between trusts are typically done to freeze the value of an old trust and move appreciation into the new trust. The old trust is typically defective because the perpetuities period will expire, assets in the trust may be subject to inclusion in the decedent's estate on audit, or the provisions are no longer applicable to the family.

exempt from the GST tax will have an inclusion ratio of zero. A trust that is fully subject to the GST tax will have an inclusion ratio of one. A trust can maintain an inclusion ratio of zero, and avoid the GST tax, for as long as it is in existence, if properly managed.

Problem: When the GST tax provisions were enacted, the law of most US states included the common law rule against perpetuities ("RAP") or some statutory version of it. To court trust business from wealthy US individuals and families, several states have eliminated their RAP provisions and allowed for "dynasty trusts," trusts that can last forever. The primary purpose of dynasty trusts is evading federal estate and GST tax for as long as possible. By placing vast amounts of wealth in dynasty trusts in states like South Dakota, US high-net-worth individuals (and even foreigners) can avoid US federal transfer taxes (and even some state level taxes) for hundreds of years, if not forever.

Proposal: Revise section 2642 to provide that after 50 years, the inclusion ratio of an exempt trust becomes one and the presence of a charitable beneficiary is disregarded for purposes of determining whether a taxable termination has occurred. Furthermore, trust assets that are decanted from an existing trust (the "original trust") into a new trust will retain the GST characteristics of the original trust.

Revenue: Small within the 10-year window.

Impose Form 3520 reporting requirement for off-shore trusts brought on-shore

Law: Section 6048(c) requires any US person that receives a distribution from a foreign trust to file a Form 3520 reporting (a) the name of the trust, (b) the aggregate amount of distributions, and (c) other information the Secretary may prescribe.

Problem: There is no consensus among tax practitioners on whether a Form 3520 must be filed when a foreign trust is brought into a US jurisdiction because domesticating a foreign trust is not technically a distribution from a foreign trust to a US person. Some practitioners will choose to file a "protective" Form 3520 to report the domestication of a foreign trust, though this is not a uniform practice.[11]

Proposal: Treat the change in status from a foreign trust to a domestic trust as a distribution to a US person that requires a Form 3520 filing under section 6048(c). Any filing requirement under this section should require information on the foreign settlor and beneficial owners of the newly domesticated trust. This requirement would put the IRS and lawmakers on notice of how much money is being brought onshore, how often, and to what extent these newly domesticated trusts may be underreporting their federal income tax liability.

Revenue: Unclear but small; more likely to generate scoreable revenue assuming IRS is adequately funded.

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[11] *See e.g.*, Caroline Jule, *IRS Form 3520, Penalties, and Whether to Make a Protective Filing*, CPA Journal (December 2017).

Simplify annual exclusion gifts for trusts

Law: The first $15,000 of gifts made to each donee in 2021 is excluded from the donor's taxable gifts. There is no limit to the number of donees to whom such gifts are made 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. The Ninth Circuit has held that a transfer to a trust can qualify as a gift of a present interest if the beneficiary has a right to withdraw the gift, even if the withdrawal right only lasts for a limited period (referred to as *Crummey* powers).

Problem: There is no limit on the number of beneficiaries to whom *Crummey* powers are given. Often, *Crummey* powers are given to multiple discretionary beneficiaries, most of whom would never receive a distribution from the trust. As a result, a significant amount of the contributions made to these trusts can be inappropriately excluded from gift tax.

Proposal: Adopt section 10 of the For the 99.5 Percent Act. This rule would revise section 2503(b) to eliminate the present interest requirement for annual exclusion gifts and define a new category of transfers (without regard to the existence of any withdrawal or put rights). An annual limit of $50,000 per donor on the donor's transfers of property within this new category would be imposed. 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 $15,000. The new category would include transfers in trust (other than to a trust described in section 2642(c)(2)), transfers of interests in passthrough entities, transfers of interests subject to a prohibition on sale, 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.

Revenue: $2.7 billion between 2016-2026, according to JCT for an identical proposal when the annual exclusion gift was $14,000. Note that this estimate assumes a lower basic exclusion amount and higher rates in the FY2017 budget.

Modify rules for establishing grantor retained annuity trusts (GRATs)

Law: Section 2702 provides that if an interest in a trust is transferred to a family member, the value of any interest retained by the grantor is zero for purposes of determining the transfer tax value of the gift to the family member(s). This rule does not apply if the retained interest is a "qualified interest." A fixed annuity, such as the annuity interest retained by the grantor of a GRAT, is one form of qualified interest, so the gift of the remainder interest in the GRAT is determined by deducting the present value of the retained annuity during the GRAT term from the fair market value of the property contributed to the trust.

Problem: GRATs are a popular technique for transferring wealth virtually free of transfer tax. Further, grantors manage the volatility of their GRATs by exchanging all or some of the highly appreciated GRAT assets for assets of equivalent value (e.g., notes). The exchange is often accomplished pursuant to the grantor's reserved power under section 675(4)(C).

Proposal: Revise section 2702(b) to provide additional requirements for GRATs such as (a) requiring a minimum term of 10 years, (b) requiring a maximum term of the life expectancy of the annuitant plus 10 years, (c) prohibiting declining annuity payments, and (d) requiring the

remainder interest have a value equal to the greater of 25% of the fair market value of the property contributed to the GRAT or $500,000 (but not to exceed the fair market value of the contributed property). Additionally, GRATs should be prohibited from selling or exchanging assets with the grantor (under rules similar to the existing prohibition on sales and exchanges for qualified personal residence trusts found in Treas. Reg. § 25.2702-5(c)(9)). A similar GRAT proposal can be found in the FY2017 Green Book.

Revenue: $3.4 billion between 2014-2024, according to JCT. Note that this estimate is only based on the proposal to impose a minimum GRAT term. Another proposal to impose a minimum GRAT term was estimated to raise $14.2 billion in revenue between 2016-2026 according to JCT, but that estimate also included revenue raised from reforming the grantor trust rules and assumes a lower basic exclusion amount and higher rates.

Curb abuse of conservation easements

Law: A taxpayer may not claim a charitable deduction for a contribution of a partial interest in property, such as a remainder interest or a grant of only certain rights with respect to a parcel of land. The Code provides an exception to the partial interest rule, however, for "qualified conservation contributions." A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes.

Problem: Some promoters are syndicating conservation easement transactions that give investors the opportunity to invest in partnerships and thereby obtain charitable contribution deductions in amounts that significantly exceed the amount invested.

Proposal: Section 138403 of the September 27 Ways and Means draft would protect the conversation easement program from abuse by limiting qualifying contributions to transactions that do not exceed 250% of a partner's adjusted basis. However, consistent with the suggestions by the October 11, 2021, Letter to Senate Finance Committee, subsection 138403(a)(8)(A) should be stricken because it is unnecessary and creates the potential for unintended avoidances. (For further discussion, see separate memorandum on conservation easements.)

Revenue: $12.5 billion between 2022-2031, according to JCT.

Limit valuation discounts on nonbusiness assets

Law: Valuation is an important concept for transfer tax because it determines the amount of transfer taxes owed. The law allows partial interests in operating businesses to be valued lower than a proportionate share of the business's total fair market value to reflect lack of marketability or lack of control.

Problem: Often, ultra-high-net worth individuals take advantage of valuation discounts in their transfer tax planning. First, they stuff non-business assets (notably liquid assets) that are beyond the reasonable needs of working capital into their family-owned businesses. Then, when they transfer partial interests in the business to their trusts or family members, the partial interest is subject to a valuation discount for purposes of calculating any transfer taxes owed. By stuffing

non-business assets into operating businesses, these taxpayers artificially reduce the value of what are otherwise liquid or passive assets.

Proposal: Adopt section 138210 of the September 27 Ways and Means draft. This proposal limits valuation discounts on non-business assets in entities that are beyond the reasonable needs of working capital for the business.

Revenue: $19.9 billion between 2022-2031, according to JCT.

Miscellaneous

Strengthen protections against investments in non-public assets and self-dealing in "Mega-Roths"

Law: There are few limitations on the types of assets that can be held in an individual retirement account (IRA) under sections 408 and 4975. Existing self-dealing rules under section 4975 allow IRA owners to invest IRA assets in entities in which they have up to a 50% interest, and to invest IRA assets in entities where they act as company officers.

Problem: Tax-preferred retirement accounts like IRAs were intended to enable the middle class to save for retirement. Ultra-wealthy individuals with access to non-public securities are able to contribute these assets to a Roth IRA and allow them to grow tax-free (reported in one case to be over $5 billion). IRA investment in entities where owners have privileged information or the ability to control entities' actions could lead to conflicts of interest or workarounds of IRA rules.

Proposal: Prohibit IRAs from holding assets that are not publicly traded, as suggested by Daniel Hemel and Steve Rosenthal in their statement for the record to the Senate Finance Committee. In addition, implement self-dealing language from section 138314 of the September 27 Ways and Means draft changing the ownership threshold for the prohibition on self-dealing for IRAs from a 50% interest in an entity to 10% interest and prohibiting investment of IRA assets where the IRA owner is an officer.

Section 138312 of the September 27 Ways and Means draft and the Retirement Improvements and Savings Enhancements Act of 2016 (RISE Act) discussion draft take different approaches to preventing IRAs from holding undervalued non-publicly traded assets. Section 138312 of the September 27 Ways and Means draft prohibits IRAs from holding assets whose issuers require IRA owners to represent that they have qualifications such as minimum income or credentials, due to the general rule that nonpublic securities are required to be sold to accredited investors. However, there are many exceptions to the general rule that nonpublic securities are required to be sold to accredited investors (including for founders' stock in Section 4(a)(2) of the Securities Act and smaller offerings in Sections 406 and 408 of Reg D, among others), and issuers often do not require such information from IRA owners in transactions involving nonpublic securities.

The RISE Act discussion draft would prohibit IRAs from holding assets acquired for less than fair market value. However, this approach would be difficult to administer since it would require IRS resources for valuation of such assets. Taxpayers could potentially also have a strong

argument that assets acquired early on in a company's life cycle were indeed acquired for fair market value.

Revenue: JCT estimated that language prohibiting IRAs from holding assets whose issuers required buyers to be licensed (similar to, but not a complete ban on nonpublic assets) would raise $1.7 billion between 2022-2031. Strengthening self-dealing rules would raise $42 million between 2022-2031.

Close capital gains loophole for exchange-traded funds

Law: Under section 852(b)(6), if an exchange-traded fund (ETF) or other regulated investment company (RIC) distributes appreciated securities or other property, no gain recognition is required.

Problem: Section 852(b)(6) allows deferral and even avoidance of tax on gains in ways that investors investing independently and even through mutual funds cannot achieve. This causes multiple negative consequences, including extreme forms of tax avoidance such as "heartbeat trades" that use in-kind redemptions.

Proposal: Repeal the exemption in section 852(b)(6) for RICs that allows them to distribute appreciated property in kind to a redeeming shareholder without realizing capital gains.
It is important that the Green Book address holes in the capital gains tax base given that the Build Back Better Act will largely not address that issue.

This proposal would bring into the capital gains tax base substantial gains that are not currently realized due to ETFs' unintended use of section 852(b)(6) for in-kind redemptions. This tax avoidance strategy has been described as a "sham", a "dodge," a "swindle," and, by one fund manager, "Wall Street's dirty little secret."

This measure is implemented at the entity level and would close a true loophole (i.e., unintended use of a statutory provision for tax avoidance). In addition, the avoidance conducted by ETFs is ultimately most beneficial to high-net-worth individuals. The flow of funds into ETFs is driven disproportionately by high-net-worth individuals – recent research found that "allocations to ETFs by investment advisors of high-net-worth clients are nearly four times more than investment advisors with low or no high-net-worth clients." As lower-income individuals have a low or zero capital gains tax rate, there is no or less tax advantage to those investors from investing through a vehicle that offers capital gains tax avoidance as a key part of its return to investors.

Revenue: $205 billion over 10 years, according to JCT.

Phase out section 199A deduction above $400,000

Law: Section 199A allows individual owners of sole proprietorships, S corporations, or partnerships to deduct up to 20% of their qualified business income, plus up to 20% of real estate investment trust dividends and qualified publicly traded partnership income. Certain types of industries (primarily white-collar service providers) are subject to income-based phase-outs beginning at $207,000 for single filers.

Problem: Section 199A benefits particular industries and not others with no logical rationale and creates regulatory complexity for small businesses. The vast majority of the tax benefit goes to the top 1% of income earners (JCT estimates 61% in 2024).

Proposal: Include the Biden campaign proposal to eliminate the section 199A deduction for filers with incomes above $400,000. It would raise more revenue and be more progressive than House and Senate proposals.

The Small Business Tax Fairness Act, introduced by Senator Wyden, eliminates industry distinctions and makes all eligible for the deduction but phases out deduction for individuals earning $400,000 and above (excluding net capital gains). It was not scored, but JCT tables from 2018 indicated the section 199A deduction benefit to individuals earning over $500,000 was $21.4 billion in 2018 and projected to be $36.9 billion in 2024.

Making the deduction more generous below the $400,000 income threshold is unnecessary and would encourage even more filers in service industries including banking, law, and consultancy to attempt to recharacterize income to get the deduction and pose major compliance risks, especially because the Administration has stated that it will focus compliance efforts on higher income filers and businesses. The September 27 Ways and Means draft would limit the total maximum deduction size to $400,000 on an individual return ($500,000 on a joint return) and raise $78.025 billion over 10 years. However, this approach would still leave in place the existing structure of a deduction that is regressive, and, if extended, would serve as a continued tax cut for wealthy filers after 2025. Since the deduction allows filers to deduct up to 20% of their qualified business income (QBI), an individual could make up to $2 million in QBI before being affected by the $400,000 maximum individual deduction.

Revenue: The Tax Policy Center estimated revenue from Biden's campaign proposal at $143.4 billion from 2021 to 2030.

Adopt selected reforms to pass-through entity rules

Proposal: In September 2021, Senate Finance Committee Chair Ron Wyden released a discussion draft of proposed changes to passthrough rules. In addition to the rules concerning gain recognition by RICs (Section 17) described above, consider including some of the other discussion draft proposals, particularly those related to the requirement to use remedial allocations (Section 3), mandatory revaluations (Section 4), and mandatory basis adjustments (Sections 13 and 14).

Revenue: JCT has produced estimates of the Wyden proposals suggesting that they raise revenues of more than $150 billion over ten years.

Reform nonqualified deferred compensation (NQDC)

Law: Section 409A allows for certain deferred compensation arrangements as long as they meet section 409A requirements, including limitations on distributions, timing of elections, etc.

Problem: This allows highly compensated individuals to defer income tax, and for a higher percentage of their compensation as compared to qualified plans.

Proposal: Implement section 409B, which was included in the House Republicans' initial Tax Cuts and Jobs Act (TCJA) proposal, requiring that all NQDC become includible in gross income once a substantial risk of forfeiture no longer exists (i.e., when required services for compensation have been performed). Stock options would be taxable in the year vested, deferred salary would be taxable in the year earned, and continuing severance payments would be taxable in the year of separation.

Revenue: JCT estimated revenue at $16.2 billion between 2018-2027 in the TCJA draft.

Limit or eliminate certain corporate tax preferences

Background: There are a number of existing proposals to limit or eliminate certain corporate tax deductions. Some of these proposals would disallow deductions for economic costs normally allowed under the corporate income tax, and others would limit corporate tax expenditures by disallowing certain tax subsidies that are not part of normal calculation of economic income (such as accelerated depreciation). We are primarily including this to note that this is a category of proposals that has been often considered for raising revenue or achieving other non-tax policy aims.

Proposal: Examples of existing proposals to limit corporate tax preferences include:

- Limiting corporate deductions for seven-figure salaries;[12]
- Limiting corporate deductions for stock options;[13]
- Eliminating deductions for direct-to-consumer pharmaceutical ads;[14] and
- Requiring straight-line depreciation over 12 years for all corporate aircraft.[15]

Revenue: Modest (and less if corporate book minimum tax is assumed).

Increase excise tax on tobacco

Tobacco prices are an effective tool for reducing youth tobacco use. Every 10% increase in the real price of cigarettes reduces childhood smoking by approximately 7%. Consider including a proposal similar to section 138504 of the Ways and Means markup. This is similar to a proposal included in several Green Books through and including FY2017. For purposes of the markup, JCT estimated this provision would raise $96B over the next decade. However, some of that revenue is attributable to a nicotine tax that remains in the Build Back Better Act. The Administration has already taken the position that these proposals do not violate the pledge to avoid tax increases on those with incomes below $400,000. The inclusion of tobacco tax

[12] See H.R. 697, the Stop Subsidizing Multimillion Dollar Corporate Bonuses Act.
[13] See S. 1375, the Ending Excessive Corporate Deductions for Stock Options Act.
[14] See S. 141, the End Taxpayer Subsidies for Drug Ads Act.
[15] See H.R. 12, the American Jobs Act of 2011, H.R. 4199, the Jets for Vets Act of 2012, and H.R. 3555, the Jobs! Jobs! Jobs! Act of 2015. Other possibilities for reform include requiring a longer straight-line depreciation schedule (e.g., 15 years), excluding corporate jets from bonus depreciation, and increasing the percentage of time the corporate jet must be used for business purposes to qualify for accelerated or bonus depreciation (e.g., from 50% to 75%).

increases in the Ways and Means markup, drew support from a wide range of health equity groups due to its potential to improve health equity.

Child Tax Credit (CTC)

We assume the Green Book will propose to make permanent (or at the very least extend through 2025), as it should, any earned income tax credit (EITC) and CTC expansions achieved in the Build Back Better Act. The Green Book should also include the important improvements to the Advance CTC's design and administration, many of which were proposed in the September 27 Ways and Means draft, but were dropped only because the one-year extension of the monthly CTC did not provide enough time to implement a transition to these sound changes.

Adopt Advance CTC design and delivery improvements proposed in the September 27 Ways and Means draft

Law: Eligibility for monthly CTC payments is estimated in advance – when claimants file their tax returns or provide information through the non-filer portal – and finalized at tax time the following year. Furthermore, children must meet several requirements under the CTC's "qualifying child" definition in order to be claimed for the credit.

Problem: Repayments of the Advance CTC may be necessary when changes in family circumstances[16], such as a parental separation or another event altering a child's living arrangements, lead to a mismatch between a filer's estimated eligibility and their final eligibility.[17] Widespread repayment obligations of child tax credits or allowances in other countries have led to significant hardship for families, political problems, and program instability. Furthermore, the "relationship test" and "residency test" under the qualifying child definition exclude hundreds of thousands of children who live with certain extended family members or close friends, or do not live with the same caregiver(s) for more than half of the year.

Proposal: Adopt several changes to the Advance CTC's design and administration proposed in section 137103 of the September 27 Ways and Means draft, including:

- Determining eligibility for the credit on a monthly (rather than annual) basis, allowing the credit to "follow the child" when they change residences.
- Adopting a "presumptive eligibility" rule, so that when someone files their taxes (or uses the non-filer portal) and prospectively claims that they expect a child to remain in their care, all payments issued to that person throughout the year would be considered "presumptively valid" unless and until another caregiver alerts the IRS that payments should go to them instead.

[16] Families experiencing changes in income that reduce the credit amount for which they are eligible are protected through the Build Back Better Act's income lookback provision.
[17] Families with low incomes are fully protected in 2022 from repayment obligations through a "safe harbor", but moderate-income families still face substantial repayment risks if they are delayed in reporting changes in circumstances to the IRS.

- Shifting to a more inclusive "specified child" definition that includes a version of a "primary caregiver" eligibility test. Some modifications could be considered based on subsequent commentary on the W&M proposal.
- Investing in a host of administrative and delivery improvements, including automatic enrollment of newborns, cross-enrollment based on other public benefits, and an expedited dispute resolution and appeals process.

Revenue: Likely small. However, other countries' experiences indicate that shifting to monthly and presumptive eligibility rules could be less expensive policies to minimize repayment risks than longer-term or permanent extension of "safe harbor" provisions.