SULLIVAN & CROMWELL LLP

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President Biden's Fiscal Year 2023 Revenue Proposals

Proposals Relating to Business, International, Individual, Real Estate, and Digital Assets Taxation

SUMMARY

On March 28, 2022, the Biden Administration (the "Administration") released the General Explanations of the Administration's Fiscal Year 2023 Revenue Proposals (commonly known as the "Green Book"). The Green Book does not include proposed statutory language, but it does contain some explanations of the Administration's fiscal year 2023 revenue proposals. The Green Book is not necessarily a preview of forthcoming legislation, and many proposals are more akin to a "policy position" than proposed legislation. However, even if not enacted by the current Congress, many Green Book proposals become the basis on which future legislation is drafted. This memorandum discusses key aspects of the Green Book relating to business taxation, international taxation, individual taxation, real estate taxation, and taxation of digital assets.

DISCUSSION

The Green Book proposals described below would generally become effective for taxable years beginning after December 31, 2022.

A. BUSINESS TAXATION

- **Corporate tax rate increase.** The Green Book proposal would increase the tax rate for C corporations from 21 percent to 28 percent.
- **Conforming "control" test to "affiliation" test.** Many corporate tax provisions turn on whether a taxpayer has "control" over a corporation. Many tax provisions use the definition of "control" set forth in section 368(c) of the Code: ownership of stock possessing at least 80 percent of the total combined voting power of all classes of voting stock and at least 80 percent ownership of the total number of shares of each class of nonvoting stock of the corporation. However, for the purpose of

determining whether a corporation is a member of an "affiliated group" under section 1504(a), "affiliation" requires ownership of 80 percent of the stock of the corporation by vote and value.[1] The Green Book proposal would conform the "control" test to the "affiliation" test in Section 1504(a). This change could affect transactions involving corporations with a high-vote/low-vote share structure.

- **Preventing so-called "basis shifting" by related-party partners.** Partnership distributions can trigger a step-up in the basis of the partnership's non-distributed property. Under the Green Book proposal, when a distribution of partnership property results in a step-up of the basis of the partnership's non-distributed property, a matching rule would be applied to prohibit any partner in the distributing partnership that is related to the distributee-partner from benefitting from the partnership's basis step-up until the distributee-partner disposes of the distributed property in a fully taxable transaction.

B. INTERNATIONAL TAXATION

- **Undertaxed profits rule.** Corporations that have substantial gross receipts and make deductible payments to foreign related parties above a specified threshold (referred to as a "base erosion payment") are subject to the Base Erosion Anti-Abuse Tax (BEAT). The Green Book proposal would repeal the BEAT regime and replace it with an Undertaxed Profits Rule (UTPR) that is consistent with the Pillar Two rules of the OECD/G20 Inclusive Framework on Base Erosion and Profits Shifting.[2] The UTPR would generally only apply to foreign-parented multinationals operating in low-tax jurisdictions and is not intended to have a material effect on U.S.-parented multinationals. Under the UTPR, domestic corporations that are part of a foreign-parented multinational group and domestic branches of foreign corporations would be disallowed U.S. tax deductions in an amount determined by reference to the "low-taxed income" of foreign entities and foreign branches that are members of the same financial reporting group. The disallowance would impose a hypothetical "top-up tax" designed to ensure that the financial reporting group as a whole pays an effective tax rate of at least 15 percent in each foreign jurisdiction in which the group has profits.
- **Tax incentives for bringing jobs onshore.** The Green Book proposal would create a new general business credit equal to 10 percent of the eligible expenses paid in connection with onshoring a U.S. trade or business. At the same time, the proposal would reduce tax benefits associated with U.S. companies moving jobs outside the United States by disallowing deductions for expenses paid or incurred in connection with offshoring a U.S. trade or business. However, the proposal does not provide guidance on what constitutes "onshoring" or "offshoring" a U.S. trade or business, nor does it provide any metric for measuring job creation or job loss.

C. INDIVIDUAL TAXATION

- **Increase of top marginal tax rate.** The Green Book proposal would increase the highest marginal tax rate to 39.6 percent. This marginal tax rate would apply to taxable income over $450,000 for married individuals filing a joint return and $400,000 for unmarried individuals.
- **Reform of capital income tax.** Under current law, long-term capital gains and qualified dividends are taxed at preferential rates, with 20 percent generally being the highest rate (23.8 percent including the net investment income tax). In addition, capital gains are not taxable when a donor transfers an appreciated asset during the donor's life, and estate beneficiaries receive a tax-free basis step-up when a decedent holds an appreciated asset at death. The Green Book proposal would increase the tax rate on long-term capital gains and qualified dividends for taxpayers with taxable income of more than $1 million to their applicable ordinary rates. Moreover, under the

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[1] Certain "plain vanilla" preferred stock may be ignored in determining control under Section 1504(a).

[2] A more detailed discussion on the UTPR and Pillar Two rules is provided in our October 12, 2021 memorandum, available here.

proposal, the donor or deceased owner of an appreciated asset would realize capital gains at the time of the gift or death.

- **Minimum income tax on high-wealth individuals.** The Green Book proposal would impose a minimum tax of 20 percent on "total income," realized or unrealized, for taxpayers with wealth over $100 million. Contrary to current law, total income under this minimum tax proposal would generally include unrealized gains. Taxpayers with wealth greater than the threshold would be required to report to the IRS on an annual basis, by asset class, the total basis and total estimated value of their assets in each specified asset class, and the total amount of their liabilities. In particular, tradable assets would be valued using end-of-year market prices, while non-tradable assets would be valued using the greater of the original or "adjusted" cost basis (reflecting a deemed floating annual return), the last valuation event from investment, borrowing, or financial statements, or other methods set forth by the Secretary. Under the proposal, taxpayers may choose to pay the first year of minimum tax liability in nine equal, annual installments. Taxpayers who are treated as "illiquid" may also elect to include only unrealized gain in tradeable assets in calculating their minimum tax liability.
- **Taxation of carried interests as ordinary income.** Under current law, gains realized in respect of "carried interests" are generally eligible to be treated as capital gains (subject to Section 1061, enacted as a part of the Tax Cuts and Jobs Act, requiring a three-year holding period in order to qualify for long-term capital gain). The Green Book proposal would generally tax a partner's share of income in respect of an "investment services partnership interest" in an investment partnership as ordinary income if the partner's total taxable income exceeds $400,000.
- **Changes to grantor trust tax rules.** Under current law, assets of a grantor trust are treated as owned by the grantor or another person for income tax purposes. Individuals who own assets that are expected to appreciate in value commonly use two techniques to remove value from their gross estates in order to reduce estate taxes: (a) funding of a Grantor Retained Annuity Trust (GRAT) with assets that are expected to appreciate in value, and (b) selling appreciating assets to a grantor trust by the deemed owner of the trust. The Green Book proposal would require the grantor's remainder interest in a GRAT at the time of the GRAT's creation to be worth at least 25 percent of the value of the assets transferred. In addition, transfers of assets to grantor trusts that are not fully revocable by the grantor would be treated as taxable for income tax purposes.
- **Limitation on use of DAF.** Private non-operating foundations are generally required to make annual "qualifying distributions" of at least 5 percent of the total fair market value of their non-charitable use assets from the preceding taxable year. Qualifying distributions generally are amounts paid to accomplish religious, charitable, scientific, or educational purposes, but also include distributions to a donor advised fund (DAF). The Green Book proposal would clarify that a distribution by a private foundation to a DAF is not a qualifying distribution unless the DAF funds are expended as a qualifying distribution by the end of the following taxable year.

D. REAL ESTATE TAXATION

- **Repeal of like-kind exchange nonrecognition rules.** Under current law, owners of appreciated real property used in a trade or business or held for investment can defer gain on the exchange of the property for real property of a "like-kind." The Green Book proposal would allow the deferral of gain only up to an aggregate amount of $500,000 for each taxpayer ($1 million in the case of married individuals filing a joint return) each year for like-kind real property exchanges. Any gains from like-kind exchanges in excess of the threshold amount would be recognized in the year of the exchange.
- **Full recapture of depreciation deduction for certain real property.** Under current law, the amount of recognized gain subject to depreciation recapture for real property generally equals the amount by which cumulative depreciation deductions exceed the sum of depreciation allowances determined by using the straight-line depreciation method and the property's applicable depreciation cost recovery period. The current depreciation recapture rule generally has minimal

application to real estate because most real property is depreciated using the straight-line method. The Green Book proposal would generally treat any gain recognized on a sale of real property held for more than one year as ordinary income to the extent of the cumulative depreciation deductions taken after the effective date of the proposal.

E. TAXATION OF DIGITAL ASSETS

- **Application of securities loan nonrecognition rules.** Under current law, loans of securities generally are eligible for nonrecognition treatment if the transfer of a security is pursuant to an agreement that meets certain requirements set forth in the Code. The Green Book proposal would expand these rules to loans of actively traded digital assets recorded on cryptographically secured distributed ledgers. The proposal would also authorize the Secretary to determine when a digital asset is actively traded and to extend the nonrecognition rules to non-actively traded digital assets and other assets, such as interests in publicly traded partnerships.
- **Application of mark-to-market rules to dealers and traders in digital assets.** Under current law, dealers in securities are required to use the mark-to-market method of accounting for securities held at year-end. Dealers in commodities and traders in securities or commodities may elect to use the mark-to-market method. Gain or loss on dealer securities or other mark-to-market assets pursuant to an election is generally treated as ordinary income or loss. The Green Book proposal would permit a dealer or trader in actively traded digital assets and derivatives on, or hedges of, those digital assets, to elect to mark to market these assets.
- **FATCA reporting for non-U.S. owners.** Under the Foreign Account Tax Compliance Act (FATCA), foreign financial institutions are generally required to report to the IRS comprehensive information about accounts with substantial U.S. owners. The Green Book proposal would provide for similar reporting for accounts maintained in the U.S. on behalf of non-U.S. owners. Further, the proposal would require financial institutions to report information regarding certain passive entities (such as trusts) and their substantial foreign owners.
- **Information reporting by digital asset brokers.** The Green Book proposal would require brokers, such as U.S. digital asset exchanges, to report information relating to the substantial foreign owners of the passive entities. The proposal, combined with existing law, would require a broker to report gross proceeds and such other information as the Secretary may require with respect to sales of digital assets with respect to customers, and in the case of certain passive entities, their substantial foreign owners.
- **Information reporting of foreign digital asset accounts** Under current law, any individual that holds at least $50,000 of specified foreign financial assets is required to report certain information on IRS Form 8938. A specified foreign financial asset currently includes: (a) a financial account maintained by a foreign financial institution, as those terms are defined by section 1471 of the Code, and (b) certain specified foreign assets not held in a financial account maintained by such a financial institution. The Green Book proposal would also require reporting with respect to any account that holds digital assets maintained by a foreign digital asset exchange or other foreign digital asset service provider.

The Green Book's proposals would also make changes to the existing law in other areas, including:

- expanding access to retroactive "qualified electing fund" elections for "passive foreign investment companies"
- expanding the definition of "foreign business entity" to include taxable units
- allowing selective basis boosts for bond-financed low-income housing credit projects
- limiting duration of generation-skipping transfer tax exemption
- limiting a partner's deduction in certain syndicated conservation easement transactions

- expanding pro rata interest expense disallowance for business-owned life insurance
- requiring employers to withhold tax on failed nonqualified deferred compensation plans

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