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Democratic House Lawmakers Release Revised Tax Proposal

Ahead of a Meeting of the House Rules Committee, Democratic House Lawmakers Unveiled a Reconciliation Bill That Includes a Variety of Federal Income Tax Law Changes

SUMMARY

On October 28, 2021, ahead of a meeting of the House Rules Committee, Democratic lawmakers released updated tax provisions of an emerging budget reconciliation package (the "Reconciliation Bill"). The Reconciliation Bill maintains many of the substantial changes to the business, individual and international income tax regimes proposed last month by the House Ways and Means Committee (the "Ways and Means Bill"). However, significant provisions of the Ways and Means Bill have been removed, including increases to the ordinary income and capital gains rates applicable to individuals, an increase to the corporate tax rate, changes to the taxation of carried interest, substantial limitations on the deduction for qualified business income earned through passthrough entities, and substantial changes to the taxation of grantor trusts. Some important features of the Reconciliation Bill are outlined below. A discussion of the Ways and Means Bill is available here.

DISCUSSION

A. BUSINESS TAXATION

- **Corporate Alternative Minimum Tax (AMT).** The Reconciliation Bill proposes a new alternative minimum tax regime applicable to corporations, effective for taxable years beginning after December 31, 2022, that was not included in the Ways and Means Bill. The proposed AMT would impose a 15% minimum tax on corporations that have three-year average annual adjusted financial statement income ("AFSI") that exceeds $1 billion. AFSI would be calculated by taking into account AFSI of certain related parties, as determined under rules that apply under current law for purposes of aggregating multiple related employers. (The proposed revisions to those rules as described below would broaden the scope of such aggregation and could significantly

expand the size of an applicable group for purposes of calculating AFSI.) Both U.S.-parented corporations and foreign-parented corporations would be tested based on their global income for purposes of the $1 billion threshold, though a U.S. group (including any CFCs) owned by a foreign parent would also be required to have income of $100 million in order to be subject to the AMT. AFSI could be offset up to 80% by financial net operating losses, and such losses could be carried forward indefinitely. Corporations would be able to claim a credit for AMT paid against general corporate income tax, similar to the tax credit that was available under the corporate AMT in effect prior to 2018 and the AMT currently in effect for individuals. If a corporation were to become subject to the AMT, the AMT would continue to apply for subsequent taxable years unless an exception (such as a change in ownership or a consistent reduction in AFSI below the applicable thresholds) became available.

- **Excise Tax on Repurchase of Corporate Stock.** The Reconciliation Bill adds a proposal that publicly traded U.S. corporations be subject to a 1% excise tax on the fair market value of any stock repurchased from shareholders during the taxable year, reduced by the value of any new issuance of stock to the public and stock issued to employees. The excise tax would also apply to subsidiaries of publicly traded U.S. corporations that make repurchases of parent stock and to U.S. subsidiaries of foreign corporations that repurchase parent stock. Exceptions to the excise tax would be available for any redemption that is treated as a dividend for tax purposes or that is tax-free pursuant to a reorganization under Section 368 (though there would apparently be no similar exception for tax-free "split-offs" under Section 355 that are not structured as reorganizations). The excise tax also would not apply to repurchases by regulated investment companies or real estate investment trusts.
- **Changes to the Limitation on Business Interest Expense Deductibility.** Consistent with the Ways and Means Bill, the existing limitation on the deductibility of business interest expense would be expanded to limit the interest deduction available to a domestic corporation (or a foreign corporation engaged in a U.S. trade or business) that is part of a multinational group that prepares consolidated financial statements and has average annual interest expense in excess of $12 million. The application of the limitation on the deductibility of business interest expense to passthrough entities would also be substantially revised so as to be determined at the partner or shareholder level rather than the entity level.
- **Limitation on Qualified Small Business Stock Gain Exclusion.** Consistent with the Ways and Means Bill, the available exclusion of gains realized on the sale of certain "qualified small business stock" would be limited to 50% of such gain for taxpayers with adjusted gross income of $400,000 or more. This limitation would apply to all sales or exchanges occurring after September 13, 2021, except for sales or exchanges entered into pursuant to a binding contract in place on or before such date.
- **Limitation on Deduction of "Excessive" Compensation.** Consistent with the Ways and Means Bill, the Reconciliation Bill would cause additional types of compensation, including performance-based compensation, commissions and post-termination compensation, to be subject to the deduction limitation applicable to "excessive" compensation and would add a new aggregation rule for purposes of determining the "employer" that is subject to the limitation.
- **Treatment of Certain Losses.** Consistent with the Ways and Means Bill, deductions for losses with respect to worthless securities and partnership interests would be treated as realized on the day that the event establishing worthlessness occurs, and losses realized upon a taxable liquidation of a corporate subsidiary within a controlled group would be deferred until the property received in the liquidation is transferred to an unrelated party.
- **Adjusted Basis Limitation for Divisive Reorganizations.** Consistent with the Ways and Means Bill, "debt for debt" exchanges that are a popular feature of many spin-off transactions would be limited to the basis of the assets transferred to "SpinCo", thus eliminating the main motivation for such exchanges. The Reconciliation Bill adds to this proposal a transition rule, which provides that these changes would not apply to any exchange made pursuant to an agreement that was

binding as of the date of enactment and at all times thereafter, described in a ruling request submitted to the IRS on or before such date, or described on or before such date in a public announcement or filing with the SEC.

- **Constructive Sales of Digital Assets; Wash Sales.** Consistent with the Ways and Means Bill, digital assets, such as cryptocurrency, would be subject to the constructive sale rules, which are anti-abuse rules that, when applicable, require a taxpayer to recognize gain with respect to an appreciated financial asset as if such asset were sold for fair market value upon adopting an economically offsetting position with respect to such asset. In addition, commodities, currencies and digital assets (such as cryptocurrencies) would become subject to the "wash sale" rules, which currently apply only to "stock and securities" and generally prevent taxpayers from claiming losses from selling and reacquiring substantially identical assets.
- **Common Control.** Consistent with the Ways and Means Bill, rules that aggregate multiple businesses for purposes of applying various provisions of the tax code (including the "small business" exception to the limit on the deductibility of business interest expense and the proposed corporate AMT as described above) would be revised to provide that non-corporate taxpayers engaged in activities treated as a trade or business for purposes of the passive activity loss rules, which includes any for-profit activity, would be treated as a "trade or business" that is subject to the aggregation rules.
- **Proposals Removed from the Ways and Means Bill.** The Reconciliation Bill does not include a number of proposals that were in the Ways and Means Bill, including proposals that would have (1) changed the taxation of partnership interests held in connection with the performance of services, (2) limited the carryforward of disallowed business interest expense, (3) modified the REIT constructive ownership rules for purposes of determining related-party rent and (4) temporarily permitted certain S corporations to reorganize as partnerships without triggering gain recognition.

B. INDIVIDUAL TAXATION

- **Surcharge on Individuals' Modified Adjusted Gross Income.** The Reconciliation Bill retains the additional tax imposed on the modified adjusted gross income of high income earners that was proposed in the Ways and Means Bill, subject to a revised rate and income thresholds. Under the Reconciliation Bill, a 5% "surcharge" would apply to individuals to the extent their modified adjusted gross income exceeds $10,000,000, or $5,000,000 for married individuals filing separately. An additional 3% surcharge would apply to individuals to the extent their modified adjusted gross income exceeds $25,000,000, or $12,500,000 for married individuals filing separately. For trusts, the 5% surcharge would apply to the extent their modified adjusted gross income exceeds $200,000, and the additional 3% surcharge would apply to the extent their modified adjusted gross income exceeds $500,000.
- **Application of Net Investment Income Tax to Trade or Business Income.** Consistent with the Ways and Means Bill, the 3.8% "net investment income tax" (also known as the "Medicare tax") would be expanded to cover net investment income above certain income thresholds for an individual, trust or estate that is derived in the ordinary course of a trade or business.
- **Limitations on Excess Business Losses of Non-Corporate Taxpayers.** Consistent with the Ways and Means Bill, the provision that disallows "excess business losses" (i.e., net business deductions in excess of business income) for non-corporate taxpayers that was enacted in 2017 and set to expire at the end of 2026 would be made permanent. In addition, excess business losses would be carried forward to future taxable years as excess business losses treated as recognized in such future taxable years (and thus would continue to be subject to the excess business loss limitation) rather than being carried forward as net operating losses.
- **Proposals Removed from the Ways and Means Bill.** The Reconciliation Bill does not include a number of significant proposals that were included in the Ways and Means Bill, including proposals

that would have (1) increased the top marginal income and capital gains tax rates for individuals, (2) substantially limited the availability of the 20% deduction for "qualified business income" earned through passthrough entities, (3) caused certain transactions between individuals and grantor trusts to be treated as recognition events and (4) changed many of the rules applicable to retirement accounts.

C. INTERNATIONAL TAXATION

- **Reduction in GILTI/FDII Deduction.** The Reconciliation Bill would reduce the deduction with respect to "global intangible low-taxed income" ("GILTI") and "foreign-derived intangible income" ("FDII") to 28.5% and 24.8%, respectively, causing the effective tax rates applicable to a domestic corporation to be 15% for GILTI and 15.8% for FDII. These amounts represent a further reduction in the amount of available deduction as compared to the Ways and Means Bill.
- **Country-by-Country Foreign Tax Credit Limitation Regime.** The Reconciliation Bill, consistent with the Ways and Means Bill, would change the foreign tax credit limitation system such that credits would be grouped on a country-by-country basis, rather than calculating an aggregate limitation on a global basis. Taxpayers thus generally would not be able to offset tax liability resulting from income recognized in low-tax countries against excess foreign tax credits resulting from taxes paid in high-tax countries. The Reconciliation Bill also includes various other revisions to the foreign tax credit regime. Unlike the Ways and Means Bill, under the Reconciliation Bill, carryforwards of foreign tax credit limitation would continue to be subject to the 10-year limit under current law, but the existing limit on carryforwards for GILTI category income would be repealed. There would be a temporary five-year carryforward period for excess limitation in the GILTI basket.
- **Modifications to Calculations of GILTI Inclusions.** Consistent with the Ways and Means Bill, the amounts that contribute to the calculation of a taxpayer's GILTI inclusion, including "CFC net tested income", "net deemed tangible income return", "qualified business asset investment" ("QBAI"), and interest expense would be calculated on a country-by-country basis under the Reconciliation Bill. The amount of allowable net deemed tangible income return would be reduced from 10% of QBAI to 5% of QBAI. Because GILTI generally equals the excess of a taxpayer's net CFC tested income over the taxpayer's net deemed intangible income return, this change would generally increase the effective tax rate on GILTI. These changes would apply with respect to taxable years beginning after December 31, 2022.
- **Increase in Deemed Paid Tax Credits.** Consistent with the Ways and Means Bill, the Reconciliation Bill would increase the "deemed paid" foreign tax credit that applies with respect to foreign taxes attributable to GILTI from 80 percent to 95 percent. However, the Reconciliation Bill would apply prospectively, rather than having retroactive effect as under the Ways and Means Bill.
- **Limitation on Deduction for Foreign-Source Dividends.** Consistent with the Ways and Means Bill, the Reconciliation Bill would limit the existing deduction for foreign-source dividends received from a foreign corporation to such dividends that are received from a CFC. Unlike the Ways and Means Bill, the Reconciliation Bill proposal would apply prospectively rather than retroactively.
- **Repeal of CFC Downward Attribution.** Consistent with the Ways and Means Bill, the Reconciliation Bill would reinstate former Section 958(b)(4), which generally prevented stock owned by a foreign person from being attributed "downward" to a U.S. person for purposes of determining whether a foreign corporation is a CFC, but would add a rule causing the GILTI and subpart F regimes to apply in the case of U.S. shareholders treated as owning at least 50% of any foreign corporation that would be a CFC if the downward attribution rules continued to apply. Unlike the Ways and Means Bill, the Reconciliation Bill proposal would apply prospectively rather than retroactively.
- **BEAT Threshold and Other Modifications.** Consistent with the Ways and Means Bill, for taxable years beginning after December 31, 2023, the Reconciliation Bill would eliminate the 3% "base

erosion percentage" threshold that must be met under current law in order for the "base erosion anti-abuse tax" ("BEAT") to apply. In addition, the Reconciliation Bill would make other changes to the BEAT regime that are consistent with the Ways and Means Bill. The BEAT rate would gradually increase from its current rate of 10% to 18% in any taxable year beginning after December 31, 2024, accelerating the timeline for such rate increases as compared to the Ways and Means Bill. The Reconciliation Bill also adds a provision that any taxpayer that is an applicable taxpayer under the BEAT regime would remain an applicable taxpayer for the succeeding 10 years.

- **Expansion of 10% Shareholder Definition for Portfolio Interest.** Consistent with the Ways and Means Bill, the Reconciliation Bill would revise the definition of "10-percent shareholder" for purposes of the "portfolio interest exemption", which currently refers in the case of a corporation only to a shareholder that owns 10% of the voting power, to include persons who own 10% or more of the vote *or* value of the corporation.
- **CFC Extraordinary Dividends.** Under the Reconciliation Bill, consistent with the Ways and Means Bill, a dividend paid by a CFC to a U.S. shareholder would be treated as an "extraordinary dividend" in the same manner as certain dividends paid by domestic corporations if the dividend is paid out of earnings and profits of the CFC that were earned while the CFC was not a CFC or while such stock was not owned by a U.S. shareholder. The Reconciliation Bill would expand such treatment to a dividend paid by a CFC to the extent the dividend is attributable to extraordinary dividends received from another CFC.
- **Partnership Interest Derivatives.** The Reconciliation Bill, consistent with the Ways and Means Bill, would treat payments with respect to notional principal contracts calculated by reference to the U.S. source income or gain of a publicly traded partnership, including one that is not engaged in a U.S. trade or business, as "dividend equivalent amounts" for purposes of federal dividend withholding tax.
- **Limitation on "Dual Capacity Taxpayers" with Respect to Foreign Tax Credits.** Consistent with the Ways and Means Bill, the Reconciliation Bill would codify an existing regulatory rule that applies to domestic corporations that are subject to tax in and receive certain benefits from a foreign country or U.S. possession. Such a corporation would not be permitted to claim a foreign tax credit for payments that are not treated as generally applicable income taxes.

D. NEXT STEPS

Democratic leadership in the House is expected to offer a single revised proposal, reflecting the product of internal negotiations, with the hopes of gaining bicameral passage and delivering a bill to the White House as early as possible. However, many of the provisions discussed above will be subject to substantial negotiation with the Senate and are likely to be further revised. Despite an expedited process in the House, enactment is not likely to occur for a least a few weeks, and could be delayed further.

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