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Senators Schumer, Manchin Introduce Inflation Reduction Act

The Proposed Act Includes a New Corporate Alternate Minimum Tax and Carried Interest Rules Changes Similar to the Past Versions of the Proposed 2021 Build Back Better Bill

SUMMARY

On July 28, 2022, Democratic Senators released updated tax provisions as part of the anticipated Inflation Reduction Act of 2022 (the "IRA"). The IRA would impose a 15% corporate alternative minimum tax on large corporations and contains changes to the "carried interest" rules under Section 1061 of the U.S. tax code. The proposals are similar to those in past versions of the Build Back Better Act which was proposed and passed by the House in November 2021 but has stalled in the Senate since then. The IRA also contains tax credit proposals for a number of green energy projects. The corporate alternative minimum tax and carried interest provisions of the IRA are outlined below. If the IRA becomes law, a separate client memorandum will detail the critical clean energy provisions. A discussion of the Build Back Better Act is available here.

DISCUSSION

A. CORPORATE ALTERNATIVE MINIMUM TAX

The IRA proposes an alternative minimum tax regime applicable to corporations effective for taxable years beginning after December 31, 2022, similar to the proposal under the Build Back Better Act.[1] The proposal would impose a 15% minimum tax on the annual adjusted financial statement income ("AFSI") of corporations that have three-year average AFSI exceeding $1 billion.[2] To determine whether a corporation has met this requirement, AFSI of corporations under common control under Section 1563(a) would be combined,[3] while, for foreign-parented corporations, AFSI of all foreign members of the U.S. corporation's "international financial reporting group" would be aggregated.[4]

AFSI is defined as the net income or loss of the taxpayer set forth on the taxpayer's applicable financial statement adjusted by specific provisions,[5] including exclusion of income in connection with a mortgage servicing contract[6] and exclusion of certain items related to a defined pension benefit pension plan,[7] until such income or items are included in gross income for tax purposes. The latter exclusion was not included in the Build Back Better Act passed by the House, but was included in the Senate Finance Committee's draft legislation released in December 2021. In the case of a U.S. shareholder of a controlled foreign corporation ("CFC"), AFSI includes the pro rata share of the AFSI of such CFC, but not below zero. Negative amounts would be carried forward and used to offset future CFC income. The proposal also authorizes the issuance of regulations regarding adjustments for corporate liquidations, organizations and reorganizations, and partnership contributions and distributions.[8]

Up to 80% of AFSI could be offset by financial statement net operating losses (as set forth on the corporation's applicable financial statement), which could be carried forward indefinitely.[9] Corporations would be able to claim certain foreign tax credits and general business credits.[10] Generally, foreign tax credits would need to be taken into account on the applicable financial statement of such entity and be "paid or accrued" for Federal income tax purposes to be used.[11] Corporations would also be able to claim a credit for amounts paid in respect of this new 15% minimum tax against future general corporate income tax, similar to the tax credit that was available under the corporate alternative minimum tax in effect prior to 2018 and the alternative minimum tax currently in effect for individuals.[12]

If a corporation were to become subject to the 15% minimum tax as a result of meeting the AFSI test, the tax would continue to apply for subsequent taxable years, unless, as a result of a change in ownership or a consistent reduction in AFSI below the applicable thresholds, the Secretary determines that such treatment is not appropriate.[13]

B. PARTNERSHIP INTERESTS HELD IN CONNECTION WITH THE PERFORMANCE OF SERVICES

The IRA includes a proposal that was in the House Ways and Means proposal of September 13, 2021 ("W&M Budget Proposal") but ultimately dropped from the Build Back Better Act. As in the W&M Budget Proposal, the existing three-year holding period requirement that must be satisfied in order for long-term capital gains rates to apply to a holder of an "applicable partnership interest" (which generally includes carried interest received in exchange for services provided to certain investment businesses) would generally be extended to five years, except in the case of certain real estate businesses and for taxpayers with adjusted gross income below $400,000.[14] Long-term capital gains treatment would be available only with respect to gains realized five years after the later of (i) the date on which the taxpayer acquired substantially all of its applicable partnership interest and (ii) the date on which the applicable partnership acquired substantially all of its assets, with similar requirements applicable in the case of tiered partnerships.[15] In addition, gain would be required to be recognized upon any transfer of an applicable partnership interest, apparently without exception for charitable transfers, nonrecognition transfers or transfers upon death.[16]

C. NEXT STEPS

The Senate Parliamentarian is expected to review and revise the IRA to be consistent with the so called "Byrd Rule" (ensuring the IRA is consistent with the reconciliation process). In addition, there may be further negotiation among Senate and House Democrats, though Democrats are hopeful that the IRA will gain bicameral passage and be delivered to the White House as soon as possible.

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ENDNOTES

1 IRA §10101(f).

2 IRA §55(b)(2), 59(k)(2).

3 IRA §59(k)(1)(D).

4 IRA §59(k)(2). The term "international financial reporting group" is currently defined by an incorrect reference to Section 163(n)(3).

5 IRA §56A.

6 IRA §56A(c)(10).

7 IRA §56(c)(11).

8 IRA §56(c)(13)(B).

9 IRA §56(d)(2).

10 IRA §§59(1), 38(c)(6)(E).

11 IRA §59(k)(1)(A).

12 IRA §53(e).

13 IRA §59(k)(1)(C).

14 IRA §1061(b)(2)(B).

15 IRA §1061(b)(2)(A).

16 IRA §1061(d).

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