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Newsletter

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United States: No one ruins a holiday weekend like the Treasury Department

In brief

President Biden released his Administration's budget proposal for fiscal year 2022 on 28 May 2021. A copy of the Budget can be found at www.whitehouse.gov/omb/budget. To accompany the Administration's Budget, the Treasury Department released its "General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals." Known generally as the "Green Book," the document includes detailed descriptions of the tax provisions in President Biden's economic proposals under the American Jobs Plan and American Families Plan, as well as accompanying revenue estimates. Though useful for planning purposes, the proposals have varying likelihoods of passage. As the familiar adage goes, "The President *pro*poses; Congress *dis*poses."

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In the first section of the Green Book, Treasury described tax proposals intended to further three key policy goals identified by the Biden Administration: (1) "reform corporate taxation," (2) "support housing and infrastructure," and (3) "prioritize clean energy."

Corporate Tax Proposals

The corporate tax proposals described in the Green Book are very similar to the proposals described in the American Jobs Plan (Fact Sheet), which was released by the Biden Administration on 31 March 2021.

These proposals include increasing the corporate income tax rate to 28% (from 21%), substantially revising the Global Intangible Low-Taxed Income (GILTI) regime, repealing the Base Erosion and Anti-Abuse Tax (BEAT) and replacing it with a new regime, entitled "Stopping Harmful Inversions and Ending Low-Tax Developments" (SHIELD), imposing a new 15% minimum tax on corporations with worldwide pre-tax book income in excess of USD 2 billion, and repealing the current deduction available to domestic corporations with respect to 37.5% of any foreign-derived intangible income (FDII).

The increased corporate income tax rate is estimated to raise USD 51 billion in fiscal year 2022 (USD 857 billion over the 2022-31 period). Reforms to the GILTI regime, in conjunction with the disallowance of deductions attributable to exempt income and tightened anti-inversion rules, are estimated to raise USD 29 billion in fiscal year 2022 (USD 533 billion over the 2022-31 period). Meanwhile, the repeal of the FDII deduction is estimated to raise USD 8 billion in fiscal year 2022 (USD 129 billion over the 2022-31 period). However, because the Green Book proposes to use the additional revenue that results from repealing FDII to expand more effective R&D investment incentives, this proposal ultimately is projected to have no revenue impact.

The proposed plan would also revise the current GILTI regime by eliminating the qualified business asset investment (QBAI) 10% exemption, reducing the Code Section 250 deduction for GILTI income to 25% (from 50% currently), repealing the high-tax exemption (under GILTI and subpart F income), and mandating a "jurisdiction-by-jurisdiction" calculation requiring a separate foreign tax credit limitation for each foreign jurisdiction. These changes would increase the effective GILTI tax rate to 21% (under the proposed 28% corporate tax rate) and prevent cross-crediting of taxes from high-tax jurisdictions to low-tax jurisdictions. Foreign oil and gas extraction income would no longer be exempt from the GILTI rules. Additionally, the amount of

a dual-capacity taxpayer's foreign levy that would qualify as creditable foreign tax would be limited to the generally applicable rate of income tax in the foreign jurisdiction.

The proposal further limits the use of foreign tax credits by extending the stock sale treatment for deemed asset sales under section 338 to hybrid entities such that the source and character of any item resulting from the sale of an interest in a hybrid entity would be determined based on the source and character the seller would have taken into account upon the sale or exchange of a stock transaction (rather than a deemed asset sale).

The proposal would replace the "BEAT" with "SHIELD." Under the SHIELD, US group members that make payments to "low-taxed members" of the same financial reporting group would be subject to a disallowance of their deductions. The SHIELD applies when the financial reporting group has more than USD 500 million in global annual revenues. A member of the group is a "low-taxed" member if the member's income is subject to an effective tax rate that is lower than a designated minimum tax rate. The designated minimum tax rate would be determined by reference to either the OECD's ongoing "Pillar Two" negotiations or, in the absence of any consensus, at the proposed GILTI rate of 21%.

Notably, on 5 June 2021, Finance Ministers from the G7 (consisting of Canada, France, Germany, Italy, Japan, the UK, and the US) committed to the principal design elements for the OECD's two pillar approach for international tax reform, including a global minimum tax of at least 15% on a country-by-country basis under Pillar Two.

To further discourage base-erosion, the Green Book resurrects the worldwide interest expense limitations that were originally considered, but ultimately eliminated from, the Tax Cuts and Jobs Act. The Green Book proposes to disallow interest expense deductions by a member of a multinational group to the extent its net interest expenses for US tax purposes exceeds the entity's proportionate share of the group's net interest expense (the "excess financial statement net interest expense"). Any disallowed interest expense could be carried forward indefinitely.

In response to Treasury's concerns that some companies report significant profits to shareholders without paying federal income taxes, the Green Book proposes a 15% minimum tax on worldwide book income for corporations whose book income exceeds USD 2 billion. While the old alternative minimum tax enacted in 1986 (P.L. 99–514, section 701–702 (1986)), was in effect, AMTI for tax years 1987 through 1989 was increased by one half of the excess of adjusted net book income over AMTI before the adjustment and before deduction of any AMT NOL. Former IRC Section 56(f). Adjusted book income was generally the net income or loss on the corporation's applicable financial statement. Former IRC Section 56(f)(3). The book income adjustment was repealed by section 11801(a)(3) of the Revenue Reconciliation Act of 1990. Perhaps these provisions will be dusted off in crafting the new 15% add-on minimum tax.

To limit the ability or incentive for domestic corporations to invert, the Green Book proposes to further tighten the existing section 7874 anti-inversion rule by reducing the continuing ownership threshold above which a non-US acquiring corporation is treated as a US corporation from 80% to 50%, and imposing a "managed and controlled" test by expanding the rule to acquisitions which don't meet the threshold requirement but otherwise evidence continuing US control. Commenters have already expressed concern that these proposals would have a negative impact on US-based companies' ability to compete with foreign-based multinationals in acquisitions.

Finally, to encourage the on-shoring of businesses, taxpayers would be eligible for a new general business credit equal to 10% of certain expenses paid or incurred in connection with moving a trade or business into the US, whereas deductions for expenses paid or incurred to move a business offshore would be correspondingly disallowed.

Effective Dates

The various proposals generally would be effective for taxable years beginning after 31 December 2021, with the exception of the increased corporate income tax rate, limit on foreign tax credits for sales of hybrid entities, and tightened section 7874 anti-inversion rule.

The 28% corporate income tax rate will be effective for taxable years beginning after 31 December 2021. However, for taxable years beginning after 1 January 2021 and before 1 January 2022, the 7-percentage point increase would be multiplied by a fraction, the numerator of which is the number of days of the portion of such taxable year falling within calendar 2022, and the denominator of which is the total number of days in such taxable year. Both the changes to section 338 and the changes to section 7874 will be effective for transactions completed after the date of enactment.

Housing and Infrastructure

To support housing and infrastructure initiatives, the Green Book proposes to expand the low-income housing tax credit, create a new tax credit program (the Neighborhood Homes Investment Credit to support construction and rehabilitation of single family homes), make permanent the New Markets Tax Credit (which provides a tax credit for investments in qualified community development entities and is scheduled to expire in 2025), and provide federally subsidized state and local bonds for

infrastructure development (such as educational facilities, public transit, passenger rail and infrastructure for zero emissions vehicles).

Incentivize Clean Energy Investments

The Green Book proposes to repeal several fossil fuel subsidies including: (1) the 15% enhanced oil recovery credit for eligible costs attributable to a qualified enhanced oil recovery project; (2) the credit for oil and gas produced from marginal wells; (3) the expensing of intangible drilling costs paid or incurred in the development of an oil or natural gas property located in the US; (4) the deduction for costs paid or incurred for any tertiary injectant used as part of a tertiary recovery method; (5) the exception to passive loss limitations provided to working interests in oil and natural gas properties; (6) the use of percentage depletion with respect to oil and gas wells; (7) two-year amortization of independent producers' geological and geophysical expenditures, instead allowing amortization over the seven-year period used by integrated oil and gas producers; (8) expensing of exploration and development costs; (9) the use of percentage depletion for hard mineral fossil fuels; (10) capital gains treatment for royalties received on the disposition of coal or lignite; (11) the exemption from the corporate income tax for publicly traded partnerships with qualifying income and gains from activities relating to fossil fuels; (12) the Oil Spill Liability Trust Fund excise tax exemption for crude oil derived from bitumen and kerogen-rich rock; and (13) accelerated amortization for air pollution control facilities.

To incentivize clean energy, the Green Book proposes to extend and enhance the Renewable Electricity Production Credit (for wind facilities), the Renewable Energy Investment Credit (for solar energy facilities), and the Residential Energy Efficiency Credit; establish a credit for taxpayer investment in electric power transmission property; create an allocated production credit for electricity generation from eligible existing nuclear power facilities that submit a bid; expand the advanced energy manufacturing tax credit in section 48C; establish tax credits for heavy and medium-duty zero emission vehicles; provide tax incentives for renewable aviation fuel; extend and enhance energy efficiency and electrification incentives; provide a disaster mitigation tax credit; expand and enhance the carbon oxide sequestration credit; and extend and enhance the electric vehicle charging station credit.

American Families Plan

The second portion of the Green Book describes proposals applicable to individuals, new reporting requirements, and other mechanisms to improve tax administration. Many of the proposals applicable to individuals were previously announced when the Biden administration unveiled the American Families Plan (Fact Sheet) on 28 April 2021.

As expected, the Green Book proposes several tax increases for wealthier individuals (earned income exceeding USD 400,000), including an increase in the top ordinary income tax rate from 37% to 39.6%. For taxpayers whose income exceeds USD 1 million, the Green Book proposes to tax capital gains and qualified dividends at ordinary income tax rates (plus the 3.8% Net Investment Income Tax ("NIIT")). This proposal, which constitutes a fundamental change to the treatment of capital gains, would be effective for gains recognized after "the date of announcement." Although it is not clear whether the "announcement" that the Green Book refers to is the release date of the Fact Sheet for the American Families Plan or the date the Green Book itself was released, a conservative approach is to treat the proposed effective date as the date the Fact Sheet was released: April 28, 2021.

The Green Book also proposes to end the step-up in basis by treating transfers of appreciated property upon death or by gift with unrealized appreciation in excess of USD 1 million as realization events, with exclusions for spousal transfers, donations, certain tangible personal property, and transfers of certain small business stock and family businesses. The new gain recognition rules would also require a trust, partnership or other non-corporate entity to recognize a capital gain if the entity's appreciated property has not otherwise been the subject of a recognition event within the prior 90 years, with a testing period beginning on 1 January 1940.

Turning to pass-through entities, the Green Book proposes to subject all trade or business income of high-income taxpayers (earned income exceeding USD 400,000) to the 3.8% Medicare tax, either through the NIIT or the SECA tax, and subject limited partners, LLC members and S corporation owners who provide services (and materially participate) to SECA tax on the distributive shares of partnership, LLC income, or business income. The proposal would also tax carried (profits) interest income as ordinary income subject to self-employment tax and repeal Section 1061 for taxpayers whose income (from all sources) exceeds USD 400,000. Qualified capital interests attributable to invested capital are not subject to this rule and the portion of gain on the sale of an interest attributable to invested capital would be taxed as capital gain.

The current gain deferral on "like-kind exchanges" of real property would be limited to an aggregate amount of USD 500,000 per year per taxpayer (USD 1 million for married individuals filing jointly). While many like-kind exchanges would not be impacted by this proposal, it would effectively eliminate Section 1031 for businesses and individuals with more valuable property.

Section 461(l), which limits non-corporate taxpayers' ability to deduct net excess business losses above a certain threshold (USD 524,000 for married individuals filing jointly and USD 262,000 for all other taxpayers in 2021), would be made permanent. Under changes made by the TCJA, section 461(l) is currently scheduled to expire at the end of 2026.

The Green Book also proposes to make certain existing credits for lower-income taxpayers permanent or expand such credits, including premium assistance tax credits for those purchasing health insurance through an Affordable Care Act marketplace, the earned income tax credit for workers without children, the child and dependent care tax credit, the child tax credit and the employer-provided childcare tax credit for businesses.

Finally, the Green Book includes additional information reporting proposals that would apply to both traditional and cryptocurrency assets. Effective for tax years beginning after 2022, the Green Book proposes to require financial institutions to file an annual information return reporting, for each account, gross inflows and outflows with a breakdown for physical cash, transactions with a foreign account, and transfers to and from another account with the same owner. The requirement would apply to all business and personal accounts above a USD 600 de minimis amount. Similar reporting requirements would apply to crypto asset exchanges and custodians. Further, where taxpayers buy crypto assets from one broker and transfer such assets to another broker, transaction reporting obligations will be imposed on businesses receiving crypto assets valued in excess of USD 10,000.

Is a Bipartisan Infrastructure Bill in the Cards?

On 24 June, the Biden administration announced the Administration's support for the Bipartisan Infrastructure Framework that a group of Democratic and Republican senators, spearheaded by Sen. Kyrsten Sinema (D-AZ) and Sen.

Rob Portman (R-OH), negotiated throughout the month of June. Although no legislative language is available yet, the broad contours of the framework are described in a Fact Sheet published on the White House website.

The Framework, which is anticipated to cost USD 1.2 trillion, includes investments in transportation (transit, rail, roads, bridges, and electric vehicle infrastructure), clean water, universal broadband, energy grid and power; remediation for legacy pollution; and to prepare for the impact of climate change, cyber attacks, and severe weather events. There are several proposed funding sources under consideration but the only tax-specific funding source is a proposal to "reduce the IRS tax gap." Although no details are provided in the Fact Sheet, reducing the tax gap generally refers to increased funding for IRS enforcement and collection of taxes due but unpaid.

Conclusion

Now that Treasury has released the Green Book and taxpayers have the benefit of proposed effective dates and additional information beyond what was provided in the Fact Sheets, taxpayers can model the impact of the proposals on their particular facts with more certainty. In addition, Congress has additional insight into the Biden Administration's preferred policy changes, which will be important as the Ways & Means Committee prepares draft tax legislation. We expect Congress and the White House to focus their efforts on drafting and passing the bipartisan infrastructure bill first, and for the tax changes described in this article to be included in a separate bill. At the time this article was written, there were outstanding procedural and political questions about whether the bipartisan infrastructure bill and the (presumably) Democratic-only tax bill would be "linked" together by Congressional leadership. Regardless of how those questions are resolved, we expect Congress to focus on introducing and passing tax legislation later this summer and in the early fall.

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