Skinny Green Book Proposes Substantial Tax Compliance and Planning Headaches

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On Friday, the Treasury Department released its general explanation of tax proposals included in President Biden's fiscal year 2022 budget submission to Congress. Often referred to as the "Green Book," this year's publication is an environmentally friendly 114 pages, compared to the average of 287 pages for the last four issued under the Obama administration, perhaps paying homage to the formation of the Sierra Club [1]. While the Green Book provides some further details regarding the President's Made in America Tax Plan (previously discussed here) and the American Families Plan (previously discussed here), it also leaves many questions unanswered. As discussed in our prior alerts, there is a great deal of uncertainty as to whether these proposals will ever become law. Nonetheless, we thought it would be helpful to highlight several of the key proposals included in the Green Book.

Specifically, the following topics are covered in this alert:

We will provide our thoughts about the Green Book's proposals regarding the energy industry and increased reporting requirements in another alert later this week.

CORPORATE TAX PROVISIONS

The Green Book contains several proposals that, if enacted, will impact C corporations.

Change in Tax Rate

The Green Book proposes to:

- Increase the income tax rate for C corporations from 21% to 28% and
- Impose a 15% minimum tax based on worldwide pre-tax book income for corporations with worldwide pre-tax book income in excess of $2 billion.

The mechanics of the minimum tax are similar to the corporate AMT that was repealed by the TCJA, in that the amount of pre-tax book income can be reduced by a "book net operating loss" and that the amount of tax can be offset by certain credits. Additionally, the taxpayer can claim a credit against future regular taxes for minimum tax previously paid.

A&M Insight: The tax rate increase is proposed to be effective for taxable years beginning after December 31, 2021. As taxpayers have done in the past with the prospect of increased tax rates, taxpayers may seek to accelerate income into the current year or defer deductions (including opting out of section 168(k) first year bonus depreciation) into future years. It is interesting that the Green Book does not mention the section 199A deduction, which President Biden had proposed to phase out for high-income taxpayers while on the campaign trail. With these rate increases and the ability to qualify for the section 199A deduction, taxpayers may want to reconsider their choice of entity status. However, it is also important to consider that the Senate Finance Committee Democratic staff are working on a series of proposals that would eliminate Section 199A benefits for high-income taxpayers.

Secondary Liability on Shareholders

The Green Book proposes to impose secondary liability, irrespective of state law rights, on shareholders who directly or indirectly dispose of at least 50% of the stock of an applicable C corporation within a 12-month period in exchange for consideration other than stock of the acquirer. For this purpose, with certain limited exceptions, an applicable C corporation is any C corporation (or successor) two thirds or more of whose assets consist of cash, passive investment assets, or assets that are the subject of a contract of sale or the sale of which has been substantially negotiated on the date that a controlling interest in its stock is sold. If applicable, the secondary liability would apply to any income taxes, interest, additions to tax, and penalties with respect to any taxable year within the 12-month period before or after the date that its stock was disposed of, if the applicable C corporation did not pay those amounts within 180 days after assessment. What is notable about the provision is that it is retroactive to sales of controlling interests occurring on or after April 10, 2013.

A&M Insight: The proposal appears to be intended to impose secondary liability only on shareholders that enter into an Intermediary Transaction Tax Shelter, which has been a listed transaction for almost 20 years and does not appear to be that prevalent (but many old cases are still being litigated). However, the proposal is estimated to generate $4.735 billion over the next 10 years, which suggests that the proposal may be much broader than it appears, including the possibility of applying in the context of a bankrupt or insolvent corporation. As a result, it would be prudent to watch for additional information about this proposal in the future.

INTERNATIONAL PROVISIONS

The Green Book includes numerous international proposals, which will increase the cost of doing business in the U.S. for both domestic and foreign-based companies, increase the cost of doing business anywhere through a domestic corporation, and increase the complexity of both compliance and tax planning for any taxpayers that are subject to U.S. tax. The following are highlights of some of the international provisions.

Changes to Global Intangible Low-Taxed Income (GILTI)

The Green Book proposes several changes to GILTI, which would be effective for taxable years beginning after December 31, 2021, including:

- Subjecting foreign oil and gas extraction income (FOGEI) to GILTI;
- Repealing of the high-tax exemption for GILTI (as well as for subpart F income);
- Requiring taxpayers to calculate their GILTI inclusion and related GILTI foreign tax credit limitations on a jurisdiction-by-jurisdiction basis;
- Eliminating the reduction of net tested income by a percentage of qualified business asset investment (QBAI);
- Reducing the amount of the section 250 GILTI deduction; and
- Adjusting the U.S. tax on GILTI, if OECD Pillar II is adopted and the U.S. taxpayer it is part of a foreign-parented group, in which the foreign parent is subject to the OECD's GILTI analog.

A&M Insight: Eliminating the high-tax exemption and requiring the calculation of GILTI on a jurisdiction-by-jurisdiction basis would increase compliance costs, as well as complexity. For example, a taxpayer that has not calculated earnings and profits of its controlled foreign corporations (CFCs) will need to do so. Additionally, CFCs that own disregarded entities or partnerships or that operate in more than one jurisdiction, may need to sub-divide their income.

Elimination of the Deduction for Foreign-Derived Intangible Income (FDII)

In addition to reducing the section 250 deduction associated with GILTI (discussed above), the Green Book proposes to eliminate the section 250 deduction for FDII for taxable years beginning after December 31, 2021.

> A&M Insight: If the deduction for FDII is repealed, cost sharing for development of intellectual property is likely to increase. U.S. corporations which are considering offshoring foreign rights to intellectual property should try to finalize those transactions in 2021.

Stopping Harmful Inversions and Ending Low-Taxed Developments (SHIELD)

The Green Book proposes to repeal TCJA's Base Erosion Anti-abuse Tax (BEAT) and replace it with the SHIELD. The SHIELD would apply to any taxable year of a financial reporting group (a group that prepares consolidated financial statements and includes at least one domestic corporation, domestic partnership, or foreign entity with a U.S. trade or business) that has more than $500 million in global revenue. If applicable, the SHIELD would disallow (wholly or partially) deductions of the domestic corporation or branch for payments to "low-taxed members" of the payor's financial group (including, in the case of a foreign-parented controlled group, the common parent). A member is low-taxed if its income is subject to (or deemed subject to) an effective tax rate that is below 21% (prior to the OECD Pillar Two agreement) or the OECD Pillar Two agreed-upon rate for purposes of the SHIELD.

The proposal to repeal BEAT and replace with SHIELD would be effective for taxable years beginning after December 31, 2022.

> A&M Insights: The SHIELD is a numerophobic's (a person who has a fear of numbers) worst nightmare. In order to appropriately calculate the SHIELD as proposed, taxpayers will be required to perform complex accounting for items not captured by traditional financial or tax accounting principles and procedures. For example, an amount that is paid to a member of the group whose effective tax rate is above the threshold, is treated as partially paid to a low-tax member of the group and therefore subject to the SHIELD by default. Additionally, the proposal appears to apply to payments that are included in the cost of goods sold, which, if enacted, may be subject to challenge.

Further Limitation on Interest Deduction

While leaving TCJA's section 163(j) limitation on interest deductions generally intact, the Green Book proposes to add an additional limitation on an entity's interest expense if:

- The entity is a member of a multinational group that prepares consolidated financial statements and
- The entity's net interest expense for U.S. tax purposes exceeds the member's proportionate share of the financial reporting group's net interest expense allocated based on EBITDA.

Like section 163(j), interest that is subject to this limitation is carried forward indefinitely until it can be used. However, unlike section 163(j), the proposal also provides for a carryforward of excess limitation into future years. Additionally, the proposal provides that if a member fails to substantiate its proportionate share of interest, or if it elects, the member's interest deduction is limited to the sum of its interest income and 10% of its section 163(j) adjusted taxable income (ATI).

> A&M Insight: If this proposal is enacted, it may be beneficial to either increase foreign borrowings to create a higher limitation for U.S. interest expense or shift existing borrowing from the U.S. to foreign group companies. Additionally, for purposes of applying the limitation, the proposal treats U.S. subgroups of a financial reporting group as a single member of the financial reporting group. As a result, financial reporting group members that are not members of a consolidated group (and file separate tax returns) are lumped together and calculate a single limitation. This added wrinkle can add a great deal of complexity in determining the limitation and its allocation.

Disallowance of Deductions Allocable to Section 245A and 250 Deductions

The Green Book proposes to recharacterize GILTI income that is eligible for the section 250 deduction and dividend income that is eligible for the section 245A participation exemption as tax-exempt income for purposes of section 265. As a result, section 265 would disallow deductions that are allocable to such income.

> A&M Insight: The proposal goes out of its way to say that nothing should be inferred from this proposal as to the state of current law. However, it is worth noting that in the past, the government has characterized the section 250 deduction as an adjustment to the effective tax rate for GILTI, as opposed to an exemption from taxation.

Limitation on Foreign Tax Credits from Sales of Hybrid Entities

Section 338(h)(16) prevents the gain from the sale of a foreign corporation by a U.S. person from being reclassified from domestic to foreign source and from capital (gain on stock sale) to ordinary (section 1248 dividend) as the result of the earnings and profits arising from the deemed asset sale by the foreign corporation. The Green Book proposes to extend the principles of section 338(h)(16) to sales of hybrid entities that are treated as corporations for foreign tax purposes but as partnerships or disregarded entities for U.S. federal income tax purposes. As a result, under the proposal, for purposes of determining the seller's foreign tax credit, the seller would be treated as selling stock in a corporation, rather than selling a partnership interest or the assets of a transparent entity.

> A&M Insight: The proposal has the potential to adversely impact the U.S. tax treatment of sales of foreign entities that are treated as pass-through entities for U.S. tax purposes but as corporations under foreign tax rules. This would include the sale of entities that were previously CFCs but that were "checked" to become pass-through entities in anticipation of their sale (so-called "check-and-sell" transactions). As the U.S. and foreign governments continue to scrutinize the use of hybrid entities, taxpayers are encouraged to examine their structures to determine if there is a more advantageous structure that can be used to accomplish the same tax results.

Inversions

In addition to targeting inversions with the SHIELD, the Green Book proposes to change the classification of transactions as inversions by treating a foreign acquiring corporation as a domestic corporation if either:

- After the acquisition, more than 50% of the stock (by vote or value) of the foreign acquiring corporation is held the former shareholders or partners of the acquired domestic corporation or partnership because of their ownership in the domestic entity, or
- Regardless of shareholder continuity, if:
    - Immediately before the transaction, the fair market value of the domestic entity is greater than that of the foreign acquiring corporation,
    - After the acquisition, the expanded affiliated group is primarily managed and controlled in the U.S., and
    - The expanded affiliated group does not conduct substantial business activities in the country in which the foreign acquiring corporation is created or organized.

> A&M Insight: As a result of these changes, the value of U.S. target companies may be reduced from the perspective of foreign buyers (due to the risk of domestic treatment irrespective of shareholder continuity) and new multinational ventures may be more likely to be formed as foreign, rather than U.S., corporations. With that in mind, the changes to the inversion rules are proposed to be effective for transactions that are completed after the date of enactment. Companies that previously decided against expatriation in light of TCJA, may reconsider whether they are able to complete a transaction prior to the date of enactment.

Credit for Onshoring Business Activity and Disallowance of Deductions for Offshoring

The Green Book proposes to create a new general business credit equal to 10% of the expenses of onshoring a previously foreign trade or business (including expenses incurred by foreign affiliates). The Green Book also proposes to disallow deductions of expenses of offshoring a U.S. trade or business, which is defined as "reducing or eliminating a trade or business or line of business currently conducted inside the United States and starting up, expanding, or otherwise moving the same trade or business to a location outside the United States, to the extent that this action results in a loss of U.S. jobs."

INDIVIDUAL PROVISIONS

The Green Book proposes to increase the tax rates applicable to certain individuals.

Change in Tax Rates

The Green Book proposes to increase the top marginal individual and fiduciary income tax rate to 39.6% for taxable years beginning after December 31, 2021. This new tax rate would apply to taxable income in excess of the 2017 top bracket threshold adjusted for inflation. For 2022, the top rate would apply to taxable income over:

- $509,300 for married individuals filing a joint return,
- $481,000 for heads of household,
- $254,650 for married individuals filing separate returns, and
- $452,700 for all other taxpayers.

Additionally, the Green Book proposes to tax certain long-term capital gains and qualified dividends at ordinary income tax rates. This new treatment would apply to the extent the taxpayer's adjusted gross income exceeds $1 million or $500,000 for a married individual filing a separate return. This treatment may be effectuated via a cut-off in which only gains recognized after the effective date (which is proposed to be "the date of announcement," which many are assuming refers to April 28, 2021, the date President Biden announced the American Families Plan) are subject to the higher tax rate, or via a blended rate, in which all gains recognized in 2021 would be subject to the same rate, which would be higher than the 2020 rate, but lower than the 2022 rate.

> A&M Insight: Similar to the tax rate increases for corporations, taxpayers subject to the increase in ordinary income tax rates may seek to accelerate income into the current year or defer deductions into future years. However, the opportunity to plan for the potential increase in capital gains rates is much more limited. With that said, taxpayers who have not filed their 2020 tax returns may consider whether they want to accelerate capital gain income into 2020, possibly including opting out of installment sale treatment.

Tax Carried Interest as Ordinary Income

The Green Book proposes to partially replace the treatment of carried interest under TCJA's section 1061 with a new regime which taxes as ordinary income a partner's allocable share of income from an "investment services partnership interest" (ISPI) and would also subject such income to self-employment taxes. The regime, which is proposed to be effective for taxable years beginning after December 31, 2021, would apply to taxpayers with taxable income in excess of $400,000. For purposes of this provision:

- An ISPI is a profits interest in an investment partnership that is held by a person who provides services to the partnership and
- An investment partnership is a partnership substantially all of the assets of which are investment-type assets (certain securities, real estate, interests in partnerships, commodities, cash or cash equivalents, or derivative contracts with respect to those assets), but only if over half of the partnership's contributed capital is received from partners in whose hands the interests constitute property not held in connection with a trade or business.

> A&M Insight: Although the title of the Green Book section suggests that it is focused on carried interests, the language of the proposal is extremely broad and could apply to individuals who are not part of the private equity or investment industry. For example, the Green Book proposal does not have the raising and returning of capital limitation that is currently included in section 1061, and thus arguably the Green Book proposal as drafted could also apply to profits interests structures commonly used to provide incentives for management of many privately-held companies.

Subject More Income to Net Investment Income (NII) and Self-Employment Contributions Act (SECA) Taxes

In addition to the carried interest proposal, the Green Book also proposes to generally subject all pass-through income of taxpayers with adjusted gross income in excess of $400,000 to either the NII or SECA tax, with certain limited exceptions. As a result, the definition of net investment income would include gross income and gain "from any trades or businesses that is not otherwise subject to employment taxes." The proposal is proposed to be effective for taxable years beginning after December 3, 2021.

> A&M Insight: The enactment of this change would largely, if not fully, eliminate the ability of taxpayers with certain tax profiles to "thread the needle" in order to avoid the application of both NII and self-employment income on operating income and gain from the disposition of flow-through activities. Given the effective date of these proposed changes, this may give founders of businesses who remain active a reason to consider accelerating a sale of their business into 2021 even if the capital gain tax rate change is retroactive.

Changes to the Estate and Gift Regime

Compared to what was anticipated, the proposed Green Book changes to the estate and gift regime are much more taxpayer-friendly. That is not to say that the proposed changes do not come with complexity. While the proposal does not generally change existing law, it does provide that transfers of property by gift or death, including transfers of property to, and distributions in kind from, a trust, partnership, or other non-corporate entity (other than a grantor trust that is deemed to be wholly owned and revocable by the donor), are treated as realization events and taxed. Therefore, a gift of appreciated property can be subject to both income tax and gift tax. Additionally, to ensure that property is not contributed to an entity to circumvent this proposal, the proposal also provides that if there has not been a recognition event in the last 90 years with respect to the property (which presumably would include a taxable sale), then the gain on the unrealized appreciation is also recognized (retroactively back to January 1, 1940). If property is subject to a realization event under this proposal, then the recipient's basis in the property will be equal to its fair market value. However, this proposed realization regime is not appliable to the transfer of certain small business stock and tangible personal property, such as household furnishings and personal effects (excluding collectibles). Additionally, the proposal excludes transfers to spouses and defers the payment of the tax on the appreciation of certain family-owned and -operated businesses until the interest in the business is sold or the business ceases to be family-owned and operated. Lastly, the proposal provides a "$1 million per-person exclusion" to the gain recognition requirement.

> A&M Insight: The Green Book proposes to apply this new realization regime to transfers made after December 31, 2021. Therefore, for the current year, taxpayers can apply traditional estate planning methods, and may in fact choose to accelerate gifts to avoid the application of this income tax. In the event transfers are not made prior to the application of this new regime, there may still be estate planning techniques to transfer value to younger generations without the imposition of this tax. It is interesting to note that the Green Book does not increase the estate tax rate or reduce the exemption amounts to their pre-TCJA level, which were proposals the President mentioned while campaigning. With the potential changes in this area, it is imperative to work with a trusted estate planner and valuation advisor to manage one's estate. Determining the fair market value of property will become increasingly important.

A&M TAXAND SAYS:

The Green Book generally provides greater detail on proposals the President had previously mentioned. However, what is most noticeable is that it does not include several provisions that taxpayers were anticipating (e.g., a greater modification to the estate and gift regime) or hoping for (e.g., the repeal of the state and local tax limitation or the ability to use net operating loss in calculating tested income or loss for GILTI). In light of this, as well as the complexity that many of the new provisions impose, taxpayers will not be cheering for the Green Book in the same manner as they did for Willie May's first home run [2]. With that said, it is important to keep in mind that the Green Book includes only the Administration's suggestions, and it now falls on Congress to determine which, if any, of the Green Book proposals that it wants to act on. The narrow Democratic margin in the House and the even division of the Senate will impact which proposals are put forward. Further, during this Congress, we have not seen a tax reform proposal from House Ways & Means Chairman Neal, and Senate Finance Committee Chairman Wyden's framework differs from that of the Green Book. Overall, the Green Book is helpful as we now have further details as to what the Administration would like to see enacted. With tax reform on the horizon, it is imperative that clients work with their trusted advisors to navigate the landscape during this uncertain time. A&M will continue to monitor the tax reform process and will provide timely updates on new developments.

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[1] The Sierra Club was formed by John Muir and others on May 28, 1892.

[2] Willie Mays hit his first major league home run off of Warren Spahn on May 28, 1951.

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