House Democrats Pass the Reconciliation Bill Torch to Senate for Scrutiny

Published on Alvarez & Marsal | Management Consulting | Professional Services
(https://www.alvarezandmarsal.com)

November 23, 2021

After months of negotiations and consideration of alternative proposals, the House Democrats advanced the Build Back Better Act reconciliation bill (the House Bill) on Friday. Now, the House Bill heads to the Senate where the Senate Parliamentarian will rule on whether provisions are directly applicable to spending and revenue, and therefore able to be included in a reconciliation bill, or whether they will need to remove the provision (or overrule the Senate Parliamentarian, which is a rather rare occurrence). Additionally, Senators Manchin and Sinema have not signed off on many of the provisions and Senators Sanders and Wyden want to add additional provisions. With that said, the proposed changes in the House Bill could have far-reaching implications on domestic and international corporations, private equity funds, and individuals. Although some provisions in the House Bill may change, and others could be added, we thought it would be helpful to discuss some of the implications of the bill, particularly noting several that would be effective upon enactment or beginning in 2022.

Highlights and observations of select tax provisions in the House Bill covered in this alert include those concerning:
Corporate Tax Provisions
International Provisions
Other Business Tax Provisions
Individual, Estate, and Trust Provisions

Corporate Tax Provisions

- Impose a 15% alternative minimum tax (AMT) on corporations (other than S corporations, regulated investment companies (RICs), and real estate investment trusts (REITs)) with an average annual adjusted financial statement income for a three-taxable year period greater than $1 billion, after applying an expanded aggregation rule (proposed separately in the House Bill and discussed here). If the corporation is foreign-parented, the AMT would apply if the $1 billion threshold would be met and the corporation has an average annual adjusted financial statement income greater than $100 million after considering a limited aggregation rule. The corporate AMT would be effective for taxable years beginning after December 31, 2022.

A&M Insight: Although lawmakers have said that the AMT is aimed at large corporations, the scope may be broader. The proposal potentially would sweep in private equity structures because the application of the proposal hinges on satisfying a threshold based on broad aggregation rules. If the AMT could apply to private equity funds under those rules, the funds may favor holding portfolio companies as passthrough entities rather than as corporations to avoid the AMT. Additionally, the proposed AMT would significantly increase the complexity of corporate tax compliance and administration because of book-tax differences and require significant clarifications.

- Impose a 1% excise tax on stock redeemed by a domestic corporation that is publicly traded on an “established securities market” or acquired by a corporation or partnership that is more than 50% owned by the publicly traded domestic corporation. The excise tax would be effective for redemptions after December 31, 2021.

A&M Insight: The excise tax could apply in unexpected cases, including reorganizations in which the shareholders recognize gain or loss, in transactions that are recharacterized under the Internal Revenue Code to include a deemed redemption, or on a distribution that is a return of capital if the corporation does not have sufficient earnings and profits (including de-SPACing transactions, where either the special purpose acquisition company (SPAC) does not find a viable target or the shareholder chooses not to participate in the SPAC’s acquisition transaction). Additionally, because the proposal would apply based on when the stock repurchases occur, mandatory redemptions that occur pursuant to the terms of stock issued prior to the enactment of the proposal could be subject to the excise tax.

- Limit the ability to distribute non-qualified preferred stock and securities, as well as cash, non-stock securities, and other non-qualifying property (commonly referred to as “boot”) in a tax-free manner to a distributing corporation’s creditors as part of certain divisive D reorganizations (e.g., spinoff transactions). The limitation would generally apply to reorganizations that occur after the date of enactment.

A&M Insight: If adopted, corporations that are considering a divisive D reorganization would need to be very careful regarding the characterization of distributions to its creditors.

International Provisions

- Modify the determination of whether a foreign corporation is a “controlled foreign corporation” (CFC) by reinstating the exception from downward attribution. The proposal is similar to the Senate Republicans’ prior proposal (discussed here), such that foreign controlled domestic shareholders can still be subject to reporting and inclusions even if the foreign corporation is not a CFC and the domestic shareholder is not a “United States shareholder” (USSH). This provision would apply to taxable years beginning after the date of enactment.

- Provide that a USSH that does not own the stock on the last relevant day of the CFC’s taxable year may still have subpart F income or a global intangible low-tax income (GILTI) inclusion for the year of the transfer. Additionally, modify the calculation of a USSH’s subpart F income or GILTI inclusion if they do own the stock of the CFC on the last relevant day. These changes would be effective for taxable years of CFCs beginning after December 31, 2021.

A&M Insight: This proposal is significant as selling shareholders may have inclusions based on the activities of a CFC after they sell shares and the tax consequences to the buying shareholders may depend on whether the CFC made a pre-transaction distribution. Additionally, it appears that the aggregate of all of the pro rata shares of subpart F and tested income/loss inclusions may be greater than the CFC’s actual subpart F and tested income/loss. Furthermore, this proposal places an even greater importance on the treatment of previously taxed earnings and profits (PTEP) and associated basis changes, for which Treasury and the IRS have yet to issue guidance on.

- Alter the GILTI computation by: (1) requiring country-by-country calculations for GILTI inclusion and related GILTI foreign tax credits (FTCs); (2) expanding the scope of income subject to GILTI; (3) reducing the benefit associated with qualified business asset investment (QBAI); and (4) increasing the effective tax rate to approximately 15%. In addition, reduce allowable foreign-derived intangible income (FDII) deduction by excluding certain income from the definition of deduction eligible income (DEI) and reducing the effective rate to approximately 15.8%. The aggregate amount of GILTI and FDII that would be eligible for the deduction would not be limited and the deduction would be included in determining whether a taxpayer has a net operating loss (NOL). Generally, GILTI and FDII modifications would be effective for taxable years beginning after December 31, 2022. However, the change in the definition of DEI would be effective for tax years beginning after the date of enactment.

A&M Insight: In addition to potentially increasing the tax liability for multinational businesses, the country-by-country calculations could significantly increase the complexity of an already complicated US international tax regime. This may encourage different business decisions, as companies may choose to begin operations of a new venture in a jurisdiction they currently operate in and where the USSHs can immediately benefit from the losses that will be generated from the new venture. Fortunately, the proposal does allow for a carryover of GILTI-related country-specific net CFC tested losses and FTCs. However, if a USSH no longer owns an interest in a CFC that operates in such a jurisdiction, it appears that the net CFC tested losses and FTCs would remain suspended.

- Modify what constitutes a base erosion payment and therefore subject to the base erosion and anti-abuse tax (BEAT), as well as incrementally increase the applicable rate of the BEAT. The modified BEAT rules would be effective for taxable years beginning after December 31, 2021.

- Impose a new limit on the interest deduction of certain US multinationals based on the allocation of the international financial reporting group's book net interest expense. The revised limit would be effective for tax years beginning after December 31, 2022.

A&M Insight: Unlike prior proposals, this proposal would apply to US multinationals, regardless of whether they are foreign parented or not. Like the corporate AMT, the new interest deduction limitation hinges on financial statement reporting, which poses its own set of complications because of book-tax timing differences. Additionally, this proposal may incentivize companies to increase their foreign borrowings to create a higher limitation for US interest expense, even if the leverage is unnecessary for non-tax business reasons.

- Limit the deduction for the foreign portion of dividends received from a 10%-owned foreign corporation to dividends received from a CFC. The revised provision would be applicable to distributions made after the date of enactment.

- Modify the treatment of sales of hybrid entities (passthrough entities for US tax purposes but taxable entities for foreign tax purposes) by recharacterizing the transaction for FTC purposes but not affecting the character of income for other purposes. This provision would generally be effective for transactions occurring after the date of enactment.

Other Business Tax Provisions

- Modify the "single employer aggregation rule" for trades or business under common control (section 52(b)) as previously discussed here.

- Limit *Granite Trust* planning by deferring the losses on specific transactions (e.g., taxable liquidations) until all property that is received in the transaction is transferred to a non-related party. The modified treatment of losses would be applicable to liquidations on or after the date of enactment.

- Treat capital assets and partnership interests that become worthless as a loss from the sale or exchange of the asset at the time of the event establishing worthlessness, with abandonment being considered as an event establishing worthlessness. This provision would be applicable to losses arising in taxable years beginning after December 31, 2021.

A&M Insight: While the purpose of this rule is unclear, it will pose a greater administrative burden as taxpayers will need to identify the event that establishes worthlessness.

- Modify the section 163(j) business interest expense deduction limitation rules so that it would apply at the partner or S corporation shareholder level rather than at the entity level. The modification for computing the deduction would be effective for tax years beginning after December 31, 2022.

- Continue to allow the immediate and full deduction of research and experimental costs for expenses paid or incurred in tax years beginning before 2026.

A&M Insight: As discussed previously here, this proposal is to reverse a Tax Cuts and Jobs Act proposal that would have no longer allowed taxpayers to immediately deduct these costs beginning in 2022. While this proposal has bipartisan support, this provision increases costs during the budget period and may be revisited in the Senate.

Individual, Estate, and Trust Provisions

- Impose a surcharge on high income individuals, estates, and trusts:
  - For individuals, impose a 5% surcharge on modified adjusted gross income in excess of $10 million for individuals (or $5 million for married filing separately) and an additional 3% surcharge (a total of 8% surcharge) on modified

adjusted gross income in excess of $25 million for individuals (or $12.5 million for married filing separately.
    - For trusts and estates impose a 5% surcharge on modified adjusted gross income in excess of $200,000 and an additional 3% surcharge (a total of 8% surcharge) on modified adjusted gross income in excess of $500,000.
    - The surcharge would be effective for taxable years beginning after December 31, 2021.

A&M Insight: Although income tax and capital gains rates are not proposed to increase, the surcharge has the effect of raising tax rates for multi-millionaires and trusts and estates. As a result, they may want to consider whether to accelerate transactions to take advantage of the lower tax rates. Additionally, the tax would be based on the taxpayer's adjusted gross income. To the extent deductions are factored into the calculation of taxable income but after adjusted gross income (e.g., charitable contributions for individuals), they would not reduce the amount of the surcharge. Lastly, this surcharge would not be treated as a tax for AMT purposes. As a result, the surcharge can apply on top of the AMT.

- Expand the application of the 3.8% net investment income tax (NIIT) for individuals with modified adjusted gross income in excess of $400,000 ($500,000 for joint filer) and trusts and estates to their income derived in the ordinary course of a trade or business, which is not subject to employment tax. The NIIT changes would be effective for tax years beginning after December 31, 2021.

A&M Insight: Business owners who plan to remain active in the business post-disposition, may want to accelerate the sale of their business this year to avoid the application of the NIIT on their distributive shares of business income.

- Limit the exclusion of gain on the sale of qualified small business stock (section 1202) gains to 50% for taxpayers with adjusted income of at least $400,000. The change in excludable gain would apply to sales and exchanges after September 13, 2021, unless a binding contract was in effect on that date and not subsequently materially modified.
- Make permanent the disallowance of the deduction of excess business losses (EBLs), which is net business deductions in excess of business income. In addition, treat disallowed losses as a deduction attributable to a trade or business in the subsequent tax year subject to the EBL rules as opposed to under current law in which they are treated as an NOL for subsequent tax years. For an estate or trust with an EBL upon termination, the deduction would be allowed as a deduction to the beneficiaries of the estate or trust. This provision would be effective for tax years beginning after December 31, 2020.

A&M Insight: This provision is taxpayer unfavorable and can have a significant effect when a taxpayer sells all of its trades or businesses and still has EBLs. In those cases, the losses cannot freely be used to offset the taxpayer's income like an NOL. Rather, the small statutory amount of $250,000, or $500,000 if married filing jointly, would be allowed to offset other income.

A&M Taxand Says

While the House Bill currently includes several of the Democrats' tax priorities, including increasing the deduction limit for state and local taxes and expanding the application of the international tax regime, it does not contain the corporate and individual tax rate increases, modification of the estate tax regime, or taxation of carried interest for which many Democrats were advocating. Nonetheless, the House Bill has far-reaching implications across the spectrum, including for domestic and foreign corporations, private equity funds, high income individuals, and some trusts and estates. The Senate is expected to make changes and push their version of the Build Back Better Act through before the end of the year, which presents tax planning challenges regarding the effects of the provisions that would be effective for tax years beginning after December 31, 2021. A&M can assist in evaluating the applicability of the myriad provisions, modeling scenarios, and assessing alternative structures, where applicable. If you would like to discuss your situation, the changes coming, and financial and operational challenges, please feel free to contact Kevin M. Jacobs, Ernesto Perez, Adam Benson, or Albert Liguori.

Related Insights:

Proposed Aggregation Rule Could Turn Private Equity ROI Analysis Upside Down

With all eyes watching the Build Back Better Act make its way through Congress, much of the attention has been on the proposed domestic and international corporate tax provisions which, if enacted, would have far-reaching implications.

Ways & Means Steps into Limelight with Tax Reform Proposal

This morning, House Democrats on the Ways and Means Committee circulated a discussion draft of legislative text which were the first signs of what they are considering including within their reconciliation package.

International Tax Reform…It Ain't Over Yet

The fourth quarter of 2021 will keep taxpayers on the edge of their seats in anticipation of what tax law changes may be included in the Democratic infrastructure bill.

Source URL:https://www.alvarezandmarsal.com/insights/house-democrats-pass-reconciliation-bill-torch-senate-scrutiny

Links:
/insights/proposed-aggregation-rule-could-turn-private-equity-roi-analysis-upside-down
/insights/ways-means-steps-limelight-tax-reform-proposal
/insights/international-tax-reformit-aint-over-yet

Authors:
Kevin M. Jacobs