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Revised U.S. Tax Proposals Will Affect Foreign Investment

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The U.S. House Committee on Rules recently released an updated version of the *Build Back Better Act* (Act) to reflect the White House's Build Back Better framework (Framework) announced on the same day (October 28, 2021). The Framework reflects a significant reduction in the scope of the Biden Administration's domestic policy goals, including its tax policy goals; however, it retains many of the core provisions featured in previous proposals. Notably, the Act would not increase the top corporate and personal income tax rates, which have been central features of the Democrats' previous proposals.

Instead of across-the-board rate increases, the Act contains revenue raisers that target certain corporate groups, high-income individuals and high-net-worth families. Non-U.S.-based corporate groups, including those held by private equity funds and pension funds, may find themselves subject to the new corporate alternative minimum tax, new interest expense deduction limitations, increased base erosion and anti-abuse tax (BEAT) rates and other provisions designed to increase revenue from inbound foreign investment into the United States. While the top marginal income and capital gains rates would not change, high-income individuals and high-net-worth families should take note of the proposed surtax on high-income taxpayers (which kicks in at much lower levels for trusts and estates) and the imposition of the 3.8% net investment income tax on certain business income.

Following the introduction of the Act, the House of Representatives passed a $1.2 trillion infrastructure bill, sending the bill to President Biden to be signed into law. The infrastructure bill contains minimal revenue raisers (primarily in the form of new cryptocurrency reporting requirements), putting pressure on Congress to push the Act through. So, it now appears more likely that some version of the Act will be adopted this year.

Generally, the tax provisions of the Act would be effective for tax years beginning after December 31, 2022, but several provisions have earlier proposed effective dates. It would be prudent for taxpayers to take whatever action they can to minimize the impact these policies would have on them.

Below we summarize some key provisions of the Act that may be of interest to our friends and clients.

Business Tax Proposals

- **Corporate Alternative Minimum Tax.** Proposed to be effective for tax years beginning after December 31, 2022, the Act would impose a 15% minimum tax on a corporation's profits as reported on its financial statements, with certain adjustments. Only corporations with average annual adjusted financial statement income in excess of $1 billion in the prior three years would be subject to the tax. However, once a corporation is subject to the minimum tax in one year, it remains subject to the minimum tax until such time as may be provided in Treasury regulations. For purposes of determining whether a corporation would be subject to the minimum tax, corporations under common control would be aggregated. For corporate groups with a foreign parent, all members of that foreign parent's international financial reporting group would be included. Accordingly, both U.S.-parented and foreign-parented groups would be tested on their global income for meeting the $1 billion annual average income threshold. In addition, U.S. members of a foreign-parented group would only be subject to the minimum tax if the average annual adjusted financial statement of the U.S. group in the prior three years is $100 million or more (including, for these purposes, income effectively connected to a U.S. trade or business and income received by a controlled foreign corporation, or CFC). Corporations subject to the minimum tax would be able to use financial statement net operating losses to offset up to 80% of adjusted financial statement income and could apply certain tax credits against the alternative minimum tax due, including foreign tax credits. The complexity of the proposed corporate alternative minimum tax will almost certainly be met with significant pushback from stakeholders. If these complex provisions are enacted, their implementation would likely require significant regulatory guidance from the Treasury Department and IRS. In the absence of such guidance, taxpayers may face difficulty in determining whether they are subject to the new minimum tax and in calculating such tax.

- **Excise Tax on Stock Buybacks.** Under the Act, beginning in 2022, publicly traded U.S. corporations that repurchase their stock would be subject to a 1% tax on the value of shares repurchased from their shareholders. The value of stock repurchased would be netted with the value of any new issuances to the public and of stock issued to the corporation's employees. This could cause publicly traded corporations to issue more stock-based incentives to employees to allow them the flexibility to engage in more stock buybacks not subject to the excise tax.
- **Interest Expense Limitation.** The Act proposes to limit the interest expense deductions of certain U.S. members of international financial reporting groups. For these purposes, all U.S. members of an international financial reporting group would be treated as one corporation. Such a corporation's interest expense deductions would be limited to an amount equal to (i) 110% of the excess of the corporation's net interest expense over the amount of interest includible in the gross income of the corporation multiplied by (ii) an "allowable percentage." The allowable percentage would be calculated as the applicable corporation's allocable share of its international financial reporting group's net interest expense over such corporation's reported net interest expense, but would not exceed 100%. This limitation would apply only to U.S. corporations whose average annual excess interest expense over a three-year period exceeds $12 million.

International Provisions

- **Global Intangible Low-Taxed Income.** The Act provides that global intangible low-taxed income (GILTI) of controlled foreign corporations would be subject to a 15% tax rate, which is in line with the OECD's recommendation for a global worldwide minimum tax under BEPS Pillar 2. A blended rate would apply for tax years straddling December 31, 2022. The amount of foreign tax credits allowable against the tax on GILTI would increase to 95% of the tax (up from 80% under current law). The Act also proposes to calculate GILTI on a country-by-country basis as well as by "taxable unit," a measure that works to further restrict the netting of income and deductions within a group. Other provisions include (i) addressing a glitch that resulted in residual tax on GILTI due to the allocation and expense rules with respect to foreign tax credits and (ii) providing for the allocation of GILTI losses and limiting the carryforward of such losses to only five years.
- **Foreign Tax Credit.** The Act proposes to calculate foreign tax credit limitations on a country-by-country basis and would also eliminate the one-year carryback of foreign tax credits allowable under current law.
- **Changes to Downward Attribution.** The Act reintroduces section 958(b)(4), which was removed by the *Tax Cuts and Jobs Act of 2017*. Section 958(b)(4) works to limit "downward attribution" of stock ownership from non-U.S. stockholders to a U.S. person. However, the Act contains a provision that would allow downward attribution to certain foreign controlled U.S. corporations that could cause such corporations to be treated as a "foreign controlled U.S. shareholder" of foreign corporations constructively owned by such U.S. corporation. Such a constructively owned foreign corporation (foreign controlled foreign corporation) would be treated as a CFC with respect to its foreign controlled U.S. shareholder. This would cause a foreign controlled U.S. shareholder to report subpart F and GILTI inclusions attributable to its direct interest in any foreign controlled foreign corporations of which it is a foreign controlled U.S. shareholder.
- **Portfolio Interest Exemption.** Proposed to be effective with respect to obligations issued after enactment, the Act would limit the availability of the so-called portfolio interest exemption on interest paid by a U.S. company to a foreign lender. Under the Act, the exemption would not be available to a lender that holds 10% or more of the voting power or value of the borrower's shares. Under current law, only voting power is used in making this eligibility determination. Non-U.S. lenders that rely on the portfolio interest exemption to avoid U.S. withholding tax will need to determine whether this proposal, if enacted, would cause them to lose access to the exemption when making future loans. If so, they should prepare to restructure their investments as necessary to avoid the potential downside of losing access to the exemption.

- **BEAT.** The Act would increase the applicable BEAT tax rate to 12.5% for years beginning in 2023; 15% for years beginning in 2024; and 18% for years beginning in 2025 and later.
- **Limitation on Tax-Free Repatriation of CFC Earnings.** Under the Act, non-taxable dividends paid by a CFC to a U.S. shareholder that are attributable to earnings and profits of the CFC from periods prior to being a CFC or attributable to stock not owned by a U.S. shareholder would reduce the recipient's basis in its stock of the CFC, thereby preserving the taxability of such amounts upon disposition of the CFC stock.

Other Provisions

- **Surtax on High-Income Taxpayers.** The Act would impose a surtax of 5% on a taxpayer's modified adjusted gross income in excess of $10 million and an additional tax of 3% (i.e., a total surtax of 8%) on such income in excess of $25 million. Trusts and estates would be subject to this surtax at much lower income thresholds. The 5% surtax would be payable on modified adjusted gross income of a trust or estate that exceeds $200,000, and the additional 3% would apply to such income of trusts or estates that exceeds $500,000. Affected trusts and estates may avoid the surtax by distributing current income to lower their adjusted gross income below the applicable threshold. In light of the relatively low threshold for applicability, high-net-worth individuals should examine their estate plans closely if the surtax is enacted.
- **Expansion of Net Investment Income Tax.** The 3.8% net investment income tax (NIIT) would be imposed on income derived in the ordinary course of a trade or business by taxpayers with more than $400,000 in taxable income (for single filers) or $500,000 (for those filing jointly). Wages subject to FICA would not be subject to the NIIT. This provision would be effective for tax years beginning after December 31, 2021.
- **Limitation on Section 1202 Exclusion for High-Income Taxpayers.** The Act would limit the exclusion of gains realized with respect to section 1202 small business stock to only those taxpayers with adjusted gross incomes of less than $400,000. The provision would also exclude trusts and estates from taking advantage of the exclusion. This limitation would apply to dispositions of section 1202 stock after September 13, 2021, subject to a binding contract exception.
- **Imposing Wash Sale Rules on Digital Assets.** Under current law, digital assets (e.g., bitcoin and other cryptocurrencies) are not subject to the "wash sale" rules that disallow a taxpayer from claiming a tax loss on the sale of a security while retaining or reacquiring an interest in such security. The Act would subject digital assets to the wash sale rules effective with respect to dispositions of digital assets after December 31, 2021.

Conclusion

Despite containing only a scaled back version of President Biden's and the Democrats' legislative wish list, the Framework and revised Act are ambitious and sweeping proposals. The tax provisions included in the Act have been redesigned with the hopes of unifying congressional Democrats in order to push the legislation through Congress using the reconciliation process. However, it remains to be seen whether the revised Act will unify the party and deliver President Biden a win on his infrastructure and tax policy proposals.

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