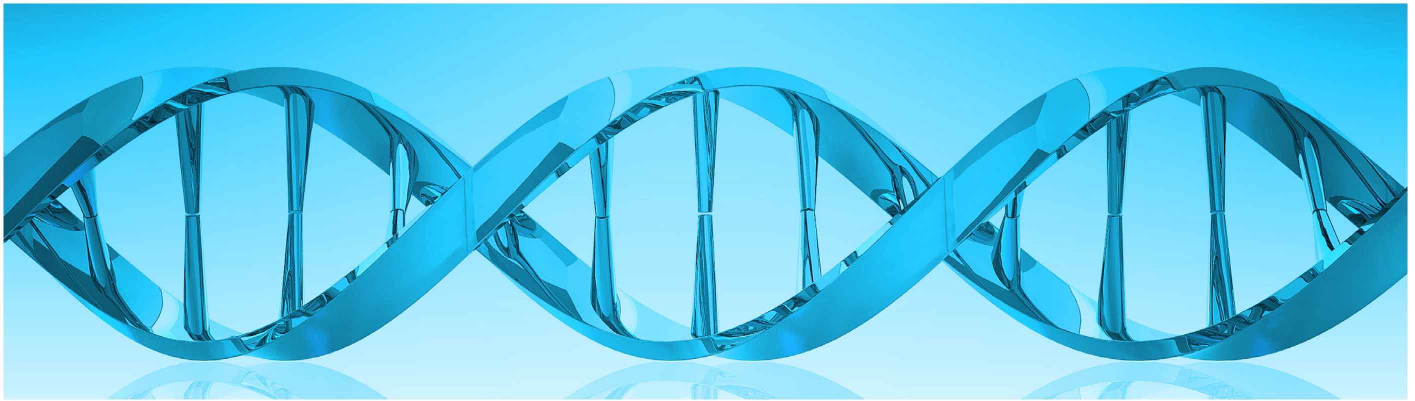

Additional Guidance Issued for President Biden's American Jobs and American Families Plan

June 2021

In April 2021, President Biden announced the "American Families Plan," which included some significant tax law changes. Among the proposed changes included in the "American Families Plan" was the increase of the tax rate that would apply to long-term capital gains, significant limitations on the amount of gain that could be deferred on the sale of real estate under the like kind exchange rules of Section 1031 of the Internal Revenue Code (the "Code") and a proposed tax event on certain investment assets that are transferred as a result of a death of the owner.

On May 28, 2021, the United State Department of Treasury issued a report entitled "General Explanation of the Administration's Fiscal 2022 Revenue Proposals. Similar reports are issued each year by the Department of Treasury as part of the annual budget process and these reports are generally referred to as the "Green Book." What is relevant is that the Green Book issues on May 28th included more details on tax law change previously proposed in President Biden's "American Families Plan."

A summary of the significant tax law changes proposed in the Green Book is below:

1. Proposed Tax Law Change Applicable to Long-Term Capital Gains of Non-Corporation Taxpayers

Entities that are taxable as C corporations for U.S. federal income tax purposes are subject to the same tax rate on taxable income regardless of whether the income is ordinary income or capital gain. In contrast, for individuals who recognize income directly or as a result of the flow through of items of income, gain, loss and deduction from a limited liability company or S corporation, a different tax rate will apply depending upon whether the income is ordinary income or capital gain.

In general, if an individual sells a capital asset that has been held for more than 12 months, the regular marginal rates referenced above do not apply and instead, tax is imposed at a rate of 20% on the excess of the amount realized on the sale over the seller's tax basis in the asset. Because these gains are passive in nature, the net investment income tax of 3.8% will also apply.

Under the proposed tax law change set forth in the Green Book, gain arising from the sale of a capital asset that has been held for more than 12 months (i.e., a long-term capital gain) would be subject to U.S. federal income tax at ordinary income rates, with the top marginal rate of 37%. This proposed

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tax rate increase would apply only to the extent that the taxpayer's income exceeds $1 million. As above, this threshold amount would be adjusted by the consumer price index that is used to index other tax rate thresholds. Under this proposal, if the sale was also subject to the 3.8% net investment income tax, the tax rate for U.S. federal tax purposes would be 40.8%.

2. Proposed Tax Law Change Applicable to Marginal Income Tax Rate

The Green Book provides, somewhat cryptically, that the above-referenced tax increase would "be effective for gains required to be recognized after the date of announcement." It is unclear if this retroactive effective date would be April 28th, the date President Biden first announced the capital gain rate proposal in the context of his "American Families Plan" proposal or if it means May 28th, the date the Green Book was released.

The TCJA changed the marginal tax brackets that applied to individuals for purposes of determining the U.S. federal income tax rate applicable to ordinary income. Under the TCJA, the top marginal tax rate for such income was lowered from 39.6% to 37% for income over $628,300 for married individuals filing a joint return (for 2021). The elimination of the 39.6% tax bracket under the TCJA was set to expire ono January 1, 2026.

The Green Book sets forth a change to the marginal tax rates to reinstate the 39.6% marginal tax rate and to have it apply to taxable income over $509,300 for married individuals filing a joint return for 2022. For future tax years, the $509,300 threshold would be adjusted by the consumer price index that is used to index other tax rate thresholds. The reinstatement of the 39.6% tax bracket and the lowering of the taxable income threshold for this top marginal rate would apply to taxable years beginning after December 31, 2021.

3. Proposed Tax Law Change Increase to the Tax Rate Applicable to C Corporations

The 2017 Tax Cuts and Jobs Act (the "TCJA") eliminated the concept of marginal tax rates for entities that are treated as C corporations for U.S. federal income tax purposes. Under the TCJA, C corporations were subject to U.S. federal income tax at a flat rate of 21%. Under the proposal outlined in the Green Book, the elimination of marginal tax rates would continue but the rate of tax would be increased to a flat 28%.

According to the information set forth in the Green Book, this tax rate increase would apply for taxable years beginning after December 31, 2021. The Green Book includes a transition rule for corporations that have a taxable year that begins after January 1, 2021 and ends after December 31, 2021 which in effect requires the higher tax rate to apply to the portion of the taxable year that occurs in 2022.

4. Proposed Tax Law Change to the Tax Treatment of Profits Interests

Over the past several years, the tax treatment of "carried interests" has been the subject of much discussion. In general terms, a "carried interest" is structured as an interest in a limited liability company or limited partnership and is granted to service providers. From a tax perspective, the "carried interest" is designed to qualify as a profits interest for U.S. federal income tax purposes so that it is tax free to the recipient on issuance. The perceived abuse is that in many cases, when distributions are made on the "carried interests" the character of the gain that flows through is capital gain rather than ordinary income (as would be the case if the payment was directly in exchange for services).

In 2017, the TCJA amended the Code to include Section 1061 to impose new tax rules on carried interest that would impose ordinary income treatment if the carried interest was held less than three years. Under the TCJA, this three year holding period required did not apply to certain real estate partnership.

Under the proposal outlined in the Green Book, the rules applicable to "carried interest" would again be changed to provide that any amount allocated to an investment services partnership interest (an "ISPI") would be subject to tax at ordinary rates regardless of the character of the gain at the partnership level. Under this proposal, the gain arising from the disposition of an ISPI would likewise be treated as ordinary income, regardless of how long the interest was held. The income allocated in respect to an IPSI would also be subject to SECA, notwithstanding whether the interest was a limited partnership interest that is otherwise exempt from SECA or a non-manager interest in an LLC. This ordinary income treatment would apply only if the individual's income from all sources exceeded $400,000.

For purposes of this proposed tax law change, an ISPI would be defined as an interest in a limited liability company or partnership held by a person that provides services to the entity and (i) substantially of the entity's assets are investment-type assets, such as securities and real estate and (ii) over half of the entity's contributed capital is from partners in whose hands the interest constitutes property not held in connection with the conduct of a trade or business. The proposal sets forth special rules that allow an interest in a limited liability company or partner held by a service provided to avoid ISPI treatment if the partner contributed capital in exchange for the interest and the interest is subject to substantially the same terms as interests issued to

non-service providers. An interest will not qualify under this "invested capital" exception if the capital contribution is funded by a loan or advance guaranteed by another partner.

The proposal would repeal Code Section 1061 and would be effective for taxable years beginning after December 31, 2021 (even if the interest was granted prior to this date).

5. Proposed Tax Law Change to the Deferral of Gain on the Sale of Real Estate under the Like Kind Exchange Rules

Section 1031 of the Code allows a taxpayer to avoid the current recognition of taxable gain on the sale of property by engaging in a like kind exchange. In 2017, the TCJA amended Section 1031 to limit application of the like kind exchange rules to real property.

The proposal set forth in the Green Book would further restrict the application of Section 1031 by limiting the amount of gain that could be deferred in a like kind exchange to $500,000 ($1,000,000 for married individuals filing a joint return). As drafted, it is unclear how this limitation would apply to REITs or property held by an entity that is taxable as a C corporation. The assumption is that the $500,000 would apply to these entities but this is not entirely clear.

The new limitation would apply to exchanges occurring after December 31, 2021.

6. Proposed Tax Law Change Applicable to the New Requirement to Recognize Long-Term Capital Gains for Assets Held at Death or Transferred During Lifetime

In general, the current tax laws provide that the recipient's basis of property acquired at death is the fair market value of those assets as of the decedent's date of death. The recipient's basis of property acquired by gift is the same as the donor's basis as of the date of such gift. There is no realization event when property is acquired at death or via gift, unless and until that property is subsequently sold (and any gain would be determined based on the recipient's adjusted basis).

Under the current proposal outlined in the Green Book, there will be a realization of capital gains to the extent such gains are in excess of a $1 million exclusion per person, upon the transfer of appreciated assets at death or by a gift, including transfers to and distributions from irrevocable trusts and partnerships. The proposal would provide various exclusions and exceptions for certain family-owned and operated businesses.

In addition, gains on unrealized appreciation will be recognized by a trust, partnership or other non-corporate entity at the end of an applicable 90-year "testing period" if that property has not been the subject of a recognition event during that testing period. The 90-year testing period for property begins on the later of January 1, 1940 or the date the property was originally acquired, with the first possible recognition event to take place on December 31, 2030.

Under the proposal outlined in the Green Book, realized gains at death could be paid over 15 years (unless the gains are from liquid assets such as publicly traded securities). There would be no gain recognition for transfers to U.S. spouses or charities at death. The Green Book states the effective date of the above-referenced changes would be effective for property transferred by gift, and property owned at death by decedents dying, after December 31, 2021.

7. Proposed Tax Law Change to Expand Income Subject to the Net Investment Income Tax or SECA Tax

Under current tax law, individuals filing joint returns that have taxable income in excess of $250,000 are subject to the 3.8% net investment income tax. In general, the net investment income tax applies only to the following categories of income and gain: (i) interest, dividends, rents, annuities and royalties, (ii) income derived from a trade or business in which the individual does not materially participate and (iii) net gain from the disposition of property (other than property held for use in a business in which the individual materially participates).

The net investment income tax does not apply to self-employment earnings. However, self-employment earnings are subject to self-employment tax ("SECA"). Under Section 1402 of the Code, limited partners are statutorily exempt from SECA, as are shareholders of an S corporation on the flow through of income from the S corporation. In general, the statutory exclusion of limited partners from SECA has been widely interpreted to also exclude members of limited liability companies from SECA.

The Green Book notes that depending upon the type of business entity used, active owners of a business can be treated differently under the net investment income tax and SECA and there are circumstance in which an active owner of a business can legally avoid the imposition of both the net investment income tax and SECA. To address this perceived abuse, the Green Book sets forth a proposal designed to ensure that all trade or business income is subject to an additional 3.8% tax either through the net investment income tax or SECA. Specifically, if an individual had adjusted gross income of more than $400,000, the net investment income tax would apply to all income and gain from a business that was not otherwise subject to SECA (or regular employment taxes).

The proposal also includes a change to the scope of SECA. Under this proposal, all individuals who provide services and materially participate in a partnership or a limited liability company would be subject to SECA on their distributive share of income that flows through from the entity. In addition, under this proposed tax law change, a shareholder of an S corporation that materially participated in the business of the S corporation would be subject to SECA on their distributive share of income that flows through from the entity.

The exemptions from SECA for rents, dividends, capital gains and certain other income would continue to apply. Nonetheless, both of these proposed tax law changes to the net investment income tax and SECA would have the effect of a 3.8% tax rate increase on all income from a business regardless of whether it was conducted through a sole proprietorship, a limited liability company, a partnership or an S corporation. The Green Book states that the effective date of the above-referenced changes would be for tax years beginning after December 31, 2021.

8. Proposed Tax Law Change to the Extend the Excess Business Loss Deduction Limitations

The TCJA added Section 461(l) to the Code to impose a limitation on the amount of loss from a pass-through business entity that can be used by a taxpayer to offset other income. As currently in force, this limitation applied to non-corporate taxpayers for tax years beginning after December 31, 2020 through 2027.

This limitation applies to "excess business losses" which are defined as the excess of losses from a business activity over the sum of (x) the gains from the business activities and (y) $524,000 for married individuals filing a joint return. This threshold amount is indexed for inflation. The determination of whether there is an "excess business loss" is determined at the individual level rather than on an entity by entity basis. As a result, all losses and gains attributable to a business are aggregated for purposes of applying the loss limitation.

Under the proposal set forth in the Green Book, this limitation would not expire after 2027 but would be permanent.

9. Proposed Tax Law Change to Require Financial Institutions to Provide Comprehensive Financial Account Information to the IRS Through 1099 Reporting

The IRS has estimated that the tax gap for business income is $166 billion per year. The IRS believes the primary cause of this tax gap is a lack of comprehensive information reporting and the resulting difficulty identifying noncompliance outside of an audit. In order to decrease the business income tax gap, it is purposed that the IRS will require comprehensive reporting on the inflows and outflows of financial accounts.

Pursuant to the proposal, financial institutions would report data on financial accounts on informational returns, which would report gross inflows and outflows from the accounts. Further, the information return would breakdown the amount of physical cash, any transactions with foreign accounts, and transfers to and from related party accounts. This regime would apply to all business and personal accounts held with financial institutions, including bank, loan, and investment accounts. It is further proposed that payment settlement entities would continue to report gross receipts on Form 1099-K, but would also report gross purchases, physical cash, payments to foreign accounts, and transfer inflows and outflows on its payee accounts. Similar reporting would also apply to cryptocurrency.

The proposal would be effective for tax years beginning after December 31, 2022.

10. Fifteen Percent Minimum Tax on Book Earnings of Large Corporations

The Green Book expresses concern about reducing the disparity between the income reported by large corporations on their federal income tax returns and the profits reported to shareholders in financial statements. Accordingly, it proposes to impose a 15% minimum tax on worldwide book income for corporations with such income in excess of $2 billion. Taxpayers would calculate book tentative minimum tax equal to 15% of worldwide pre-tax book income less certain tax credits. The book income tax equals the excess, if any, of tentative minimum tax over regular tax. The proposal would be effective for taxable years beginning after December 31, 2021.

11. Proposed Changes to Global Intangible Low-Taxed Income ("GILTI")

The TCJA enacted the GILTI rules as a sort of minimum tax on earnings of controlled foreign corporations ("CFC's"). A U.S. shareholder's GILTI inclusion is determined by combining its pro rata share of the tested income and tested loss of all its CFCs. Tested income is the excess of certain gross income of the CFC over the deductions of the CFC that are properly allocable to the CFC's gross tested income. However, this inclusion is reduced by a deemed 10% return on depreciable tangible property of the CFC (referred to as qualified business asset income, or "QBAI").

In addition, a corporate U.S. shareholder is generally allowed a 50%

deduction against its GILTI inclusion. Further, for corporate U.S. shareholders, 80% of foreign corporate income taxes attributable to GILTI may be allowed as a foreign tax credit. Finally, Treasury Regulations provide that if the foreign effective tax rate on the gross income of a CFC exceeds 90% of the U.S. corporate income tax rate, the U.S. shareholder of the CFC is generally permitted to exclude that gross income (and the associated deductions and foreign income taxes) from its GILTI inclusion.

The Green Book proposal would make several changes to these rules. First, the QBAI exemption would be eliminated, so that the U.S. shareholder's entire CFC tested income would be subject to U.S. tax. Second, the section 250 deduction for a global minimum tax inclusion would be reduced to 25%. Given the increased corporate tax rate, the GILTI tax rate would generally increase to 21% (disregarding the effect of any available foreign tax credits). Third, the averaging method for calculating a U.S. shareholder's GILTI inclusion would be replaced with a per country rule. Under this standard, a U.S. shareholder's GILTI inclusion would be determined separately for each foreign jurisdiction in which its CFCs have operations. Concomitantly, a separate foreign tax credit limitation would be required for each foreign jurisdiction. Finally, the proposal would repeal the high tax exemption (for both GILTI income and subpart F income). These proposals would be effective for taxable years beginning after December 31, 2021.

Taken together, these changes will substantially increase the tax rate of many U.S. multinationals on foreign income. The Green Book proposals essentially enact a full inclusion regime, which is exacerbated by the inability of U.S. shareholders to offset losses in one country against income in another. Further, the increased tax rate resulting from the combination of an increased corporate tax rate and reduced GILTI deduction coupled with the per-country limitations on foreign tax credits will substantially increase some taxpayers' effective tax rates on foreign income.

12. Enact New Limitations on Corporate Tax Base Erosion

a. Elimination of Foreign-Derived Intangible Income ("FDII") Provisions

The FDII provisions (also a TCJA enactment) were intended to encourage exports of intangible property and services. Very generally, FDII is the excess of the taxpayer's income from certain U.S. sources derived in connection with property or services that are sold by the taxpayer to a foreign person for a foreign use over the amount of QBAI used to produce such property.

Believing that FDII is not an effective way to encourage research and development (R&D) in the United States, rewards prior innovation rather than incentivizing new R&D and incentives companies to offshore manufacturing, the Green Book proposes to repeal FDII in its entirety. The Green Book indicates that the resulting revenue will be used to incentivize R&D in the United States but provides no details on how this will be done. The repeal would be effective for taxable years beginning after December 31, 2021.

b. Repeal of Base Erosion Anti-Abuse Tax ("BEAT"); Enactment of Stopping Harmful Inversions and Ending Low-Tax Developments ("SHIELD") Law

The BEAT was another TCJA innovation. Under the BEAT rules, a minimum tax was imposed on certain large corporate taxpayers that also make deductible payments to foreign related parties above a specified threshold. A taxpayer's BEAT liability is computed by reference to the taxpayer's modified taxable income and comparing the resulting amount to the taxpayer's regular tax liability. The taxpayer's BEAT liability generally equals the difference, if any, between 10% of the taxpayer's modified taxable income and the taxpayer's regular tax liability.

The Green Book proposal would repeal the BEAT and replace it with a new rule referred to as SHIELD. Under SHIELD, a deduction (whether related or unrelated party deductions) would be disallowed to a domestic corporation or branch, in whole or in part, by reference to all gross payments that are made (or deemed made) to "low-taxed members," which is any financial reporting group member whose income is subject to an effective tax rate that is below a designated minimum tax rate. The designated minimum tax rate will be determined by reference to a rate agreed to under one of the pillars of the Base Erosion and Profit Shifting plan put forth by the OECD. If SHIELD is in effect before agreement has been reached, the designated minimum tax rate trigger will be 21%.

A financial reporting group is any group of business entities that prepares consolidated financial statements and that includes at least one domestic corporation, domestic partnership, or foreign entity with a U.S. trade or business. Consolidated financial statements means those determined in accordance with U.S. GAAP, IFRS or another method authorized by the Treasury Department. A financial reporting group member's effective tax rate is determined based on the members' separate financial statements on a jurisdiction by jurisdiction basis. Payments made by a domestic corporation or branch directly to low-tax members would be subject to the SHIELD rule in their entirety. Payments made to financial reporting group members that are not low-tax members would be partially subject to the SHIELD rule based on the aggregate ratio of the

financial reporting group's low-taxed profits to its total profits.

The proposal provides authority for the Secretary to exempt from SHIELD payments in respect of financial reporting groups that meet, on a jurisdiction-by-jurisdiction basis, a minimum effective level of tax. The SHIELD rule would apply to financial reporting groups with greater than $500 million in global annual revenues and would be effective for taxable years beginning after December 31, 2022.

c. New Deduction Limitations on Disproportionate United States Borrowings

The Green Book expresses concern that under current law multinational groups are able to reduce their U.S. tax on income earned from U.S. operations by over-leveraging their U.S. operations relative to those located in lower-tax jurisdictions. Under the proposal, a financial reporting group member's deduction for interest expense generally would be limited if the member has net interest expense for U.S. tax purposes and the member's net interest expense for financial reporting purposes (computed on a separate company basis) exceeds the member's proportionate share of the group's net interest expense reported on the group's consolidated financial statements. A member's proportionate share of the financial reporting group's net interest expense would be determined based on the member's proportionate share of the group's earnings (computed by adding back net interest expense, tax expense, depreciation, depletion, and amortization) reflected in the financial reporting group's consolidated financial statements.

When a financial reporting group member has excess financial statement net interest expense, a deduction will be disallowed for the member's excess net interest expense for U.S. tax purposes. For this purpose, the member's excess net interest expense equals the member's net interest expense for U.S. tax purposes multiplied by the ratio of the member's excess financial statement net interest expense to the member's net interest expense for financial reporting purposes. However, certain financial services entities would be excluded from the financial reporting group. Further, the proposal would not apply to financial reporting groups that would otherwise report less than $5 million of net interest expense, in the aggregate, on one or more U.S. income tax returns for a taxable year.

A member of a financial reporting group that is subject to the proposal would continue to be subject to the application of thin capitalization rules (section 163(j)). Thus, the amount of interest expense disallowed for a taxable year of a taxpayer that is subject to both interest expense disallowance provisions would be determined based on whichever of the two provisions imposes the lower limitation. A member of a financial reporting group may also be subject to the Shield rule, discussed above.

The continued proliferation of interest deduction limitations is likely to be of concern to multinational groups that would now need to consider not only the application of debt-equity rules and thin capitalization rules but also the rules on disproportionate United States borrowings and, possibly, the SHIELD rules.

Further, as lenders often want to lend to the parent of multinational groups (and those groups often want to maximize their borrowing capacity), it is typical for a U.S. parented multinational to be the primary borrower and cause its foreign subsidiaries to guarantee the debt obligation. The proposed limitation on disproportionate United States borrowings may force those borrowers to seek ways to introduce leverage into their foreign subsidiaries or cause these subsidiaries to become co-borrowers. However, doing so may require running the gauntlet of interest deduction limitations, withholding taxes and foreign exchange requirements in numerous countries.

d. Provide New Business Credit for On-Shoring a U.S. Trade or Business

The proposal would create a new general business credit equal to 10% of the eligible expenses paid or incurred in connection with onshoring a U.S. trade or business. For this purpose, onshoring a U.S. trade or business means reducing or eliminating a trade or business currently conducted outside the United States and starting up, expanding, or otherwise moving the same trade or business to a location within the United States, to the extent that this action results in an increase in U.S. jobs. In addition, the proposal would disallow deductions for expenses paid or incurred in connection with offshoring a U.S. trade or business.

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