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Biden Proposes to Sharply Increase Taxes on Corporations and High-Income Individuals, While Encouraging Investment in Renewable Energy

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As expected, President Biden's administration released a $6-trillion budget proposal for the coming fiscal year (Budget), including $3.6 trillion of tax increases over 10 years and generous tax credits to incentivize clean energy and certain infrastructure projects. The Treasury Department explains tax-related aspects of the Budget in its accompanying "Green Book." The policies discussed in the Green Book will likely be subject to intense partisan negotiation as the budget legislation moves through Congress. If Congress cannot reach a bipartisan agreement, the Democrats may use the budget reconciliation procedure, much like the Republicans did when they used the process to pass the *Tax Cuts and Jobs Act of 2017*. Reconciliation allows Congress to pass budget-related legislation with a simple majority in the Senate, which would allow the Democrats to pass such legislation on party lines, provided that such legislation does not lose the support of even a single moderate Democrat in the Senate. In the background of many of the proposed international tax changes, the administration has indicated to OECD negotiators its support of a worldwide minimum tax rate of 15%. While it is too early to determine whether these proposals will become law as currently drafted, clients would be well advised to consider the details of these proposals, which are likely to receive a great deal of attention from business and individual taxpayers, as well as from the press, academics, and non-U.S. governments.

As revealed in greater detail below, the Budget includes a host of provisions affecting international structures that are intended to discourage moving U.S. jobs, intellectual property, and economic activity offshore, while narrowing tax deferral and increasing taxes on both offshore and onshore operations. Incentives to bring operations onshore and disincentives to move operations offshore would be expanded. Taxes would be increased across a broad array of economic activity, and incentives for investment in clean (renewable) energy would be expanded. Most of the changes would be effective prospectively (generally for taxable years beginning after December 31, 2021). Finally, the Budget includes a large increase in funding for compliance efforts by the IRS, and revenue estimates indicate that the Treasury Department expects such increased funding to result in a significant increase in tax collections.

The Green Book provides details of the following highlighted items, and much more:

- Tax rates would increase, moving the maximum income tax rate for corporations to 28%, from 21%, and for individuals, trusts and estates to 39.6%, from 37%.
- Current taxation of offshore subsidiaries' income would increase to 21% while credits for foreign taxes would be limited on a country-by-country basis.
- The unpopular base erosion and anti-abuse tax (BEAT) would be replaced by a new regime that would deny corporate deductions for payments to foreign (i.e., non-U.S.) related persons that are subject to a low effective tax rate, a regime referred to by the acronym SHIELD (Stopping Harmful Inversions and Ending Low-Tax Developments).
- Large corporations would be subject to a 15% minimum tax on book income.
- Interest deductions of a corporate group would be further limited if the group's worldwide leverage is lower than its leverage in the United States.

- A tax credit of up to 10% would be available for business brought back to the United States and disincentives are proposed for corporate inversions (by tightening trigger events) and offshoring new business (through the disallowance of certain deductions related to moving business offshore).
- Carried interests and long-term capital gains would be taxed as ordinary income to non-corporate taxpayers. Subjecting long-term capital gains to ordinary income rates is proposed to be effective retroactive to the date of announcement.
- Like-kind exchanges, previously available for real estate, would no longer be tax-deferred (except for a small amount per taxpayer per year).
- Losses from pass-through businesses allocable to non-corporate taxpayers would be permanently limited to offsetting only $250,000 of nonbusiness income per year.
- The 3.8% net investment income tax on individuals (but not nonresident aliens) would apply to income earned through investments in pass-through businesses as well as traditional investments.
- Income tax would be imposed on transfers of certain appreciated assets by gift or at death, and anti-abuse rules would prevent planning through lifetime gifts or holding assets through trusts or partnerships. Transfers to a surviving spouse and to charities would not trigger tax. Tax on a closely held business could be deferred, and financing provisions are proposed to ease certain liquidity concerns. The income tax imposed at death would be deductible in computing the amount subject to estate tax.
- The current incentive for export activity known as "FDII" (foreign derived intangible income) would be repealed. In its place, the Budget includes, without detail, an intention to provide new research and development incentives using the revenue raised by eliminating FDII.
- Clean energy tax incentives would include an extension of existing tax credits and rebates on qualified purchases of electric power transmission property.

This bulletin highlights the tax proposals in the Biden administration's proposed budget for fiscal year 2022 (Budget) as explained in the U.S. Treasury Department's General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals (Green Book), with an emphasis on business-related concerns and international matters. Most of the policies discussed in the Green Book are proposed to be effective for taxable years beginning after December 31, 2021. Our review here focuses on the federal tax consequences of the proposals, but many would be expected to affect state, and possibly local, income and estate or inheritance taxes. At present, these policies are only proposals and will likely be subject to extensive negotiation before taking final form. However, due to the possibility that these policies could have wide-reaching effects on businesses and high-income taxpayers, taxpayers should begin considering how they may be affected if these policies are enacted.

Key Proposals Affecting Businesses

Corporate Tax Rate Increase

The federal corporate income tax rate would rise to 28%, from 21%, effective for taxable years beginning after December 31, 2021. Fiscal year taxpayers with taxable years beginning in 2021 and ending in 2022 would be subject to a blended rate.

International Tax Changes

Global intangible low-taxed income. The Budget proposes substantial changes to the GILTI regime introduced by the *Tax Cuts and Jobs Act of 2017* (TCJA). Specifically, the "qualified business asset income" (QBAI) exemption, which is calculated as a deemed 10% return on depreciable tangible assets, would be eliminated. The removal of this exemption would result in nearly all foreign income of U.S. corporate groups being taxed under either GILTI or subpart F, rendering the participation exemption under section 245A effectively irrelevant as the earnings underlying such dividends will have been subject to U.S. tax upon being earned by the relevant controlled foreign corporation (CFC). Furthermore, the effective rate of tax on GILTI for U.S. corporate shareholders of CFCs is proposed to be increased by reducing the section 250 deduction from 50% to 25%, which, when combined with the increased corporate tax rate of 28%, would result in an effective tax rate on GILTI of 21% – double the current 10.5% effective rate. Additionally, the Budget proposes calculating GILTI and any foreign tax credits allowable against GILTI on a country-by-country basis. Assuming that the 80% limitation on such foreign tax credits being taken against GILTI remains in place, GILTI will need to be subject to a minimum 26.25% in the jurisdiction in which it is earned to avoid residual U.S. tax on such income. These changes would be effective for taxable years beginning after December 31, 2021.

Drop the BEAT and get a SHIELD. Under this proposal, the base erosion and anti-abuse tax (BEAT) would be replaced with the Stopping Harmful Inversions and Ending Low-Tax Developments (SHIELD) rule effective for taxable years beginning after December 31, 2022. SHIELD would disallow deductions to U.S. corporations for certain payments made to members of its financial reporting group that are not subject to at least a certain minimum tax rate, which would be either 21% or a rate agreed upon in the future under OECD/BEPS Pillar Two. A financial reporting group is a group of entities that prepare a consolidated financial statement including at least one U.S. corporation, U.S. partnership or foreign entity with a U.S. trade or business. Additionally, payments to a member of the financial reporting group that is not a low-tax member could be partially subject to SHIELD to the extent that other members of the group are subject to a low tax rate. SHIELD would generally apply to financial reporting groups with more than $500 million in global annual revenues, with exceptions for (i) certain financial reporting groups that meet a minimum effective level of tax on a jurisdiction-by-jurisdiction basis and (ii) payments made to certain investment funds, pension funds, international organizations or nonprofit entities. The repeal of BEAT and its replacement with SHIELD would be effective for taxable years beginning after December 31, 2022.

Minimum tax on worldwide book income. The Budget proposes a 15% minimum tax on the worldwide pre-tax book income of corporations with book incomes in excess of $2 billion annually, effective for taxable years beginning after December 31, 2021. The Green Book notes that this policy is intended to bring the United States tax code in line with the OECD's push for a global minimum tax while addressing the gap between profits reported to shareholders and the amount of taxable income reported to the IRS. This proposal is also notable (i) for its reliance on financial accounting standards as a starting point for determining U.S. tax liability, which cedes some control of the U.S. tax function to third parties, and (ii) for reintroducing the complexity of two parallel tax regimes, much like the corporate alternative minimum tax that was repealed as part of the TCJA. Further to this proposal, the Treasury Department has issued reports indicating its support for the OECD to adopt a global minimum corporate tax rate of 15%. A broad OECD resolution to adopt a 15% global minimum tax could be reached while the Budget is still being considered by Congress. Were an OECD deal to be struck during the legislative process, it could prove significant in the discussions being held about U.S. tax reform.

Limiting deductions for disproportionate interest expenses. This proposal would disallow deductions for certain interest expenses paid by U.S. members of a multinational group that prepares consolidated financial statements. Such interest deductions would be disallowed to the extent that the U.S. entity's net interest expense exceeds its proportionate share of the group's net interest expense as reported in the group's financial statements (based on the member's proportionate share of the group's earnings). If the entity fails to substantiate its proportionate share of the group's interest expense, the entity's interest expense deduction would be limited to the sum of its interest income and 10% of its adjusted taxable income (as defined under section 163(j)). This proposal would not apply to financial services entities, which entities would also be excluded from their financial reporting groups for purposes of applying this rule to other members of the group. The rule also would not apply to groups that report less than $5 million total of net interest expense on one or more U.S. tax returns in the taxable year. This limitation would be effective for taxable years beginning after December 31, 2021.

Strengthening anti-inversion rules. The Budget proposes that the anti-inversion rules of section 7874 be expanded to capture even more transactions designed to remove income from the U.S. tax base. Currently, section 7874 generally applies to the direct or indirect acquisition of the properties of a U.S. corporation or properties constituting a U.S. trade or business of a U.S. partnership by a foreign corporation if, after such acquisition, the former shareholders of the U.S. corporation or former owners of the U.S. partnership own 80% or more of the foreign acquiring corporation, and thereby causes the foreign corporation to be treated as a U.S. corporation for federal income tax purposes. If the former shareholders or owners of the acquired U.S. entity own at least 60% but less than 80% of the foreign acquirer, the foreign corporation may be subject to additional tax, but is not treated as a U.S. corporation. The proposal would replace the 80% threshold with a 50% threshold and eliminate the 60% test entirely. In addition, an alternative test would treat a foreign acquirer as a U.S. corporation if (i) immediately prior to the acquisition, the fair market value (FMV) of the U.S. entity is greater than the FMV of the acquiring corporation; (ii) after the acquisition, the "expanded affiliate group" is primarily managed and controlled in the United States; and (iii) the expanded affiliate group does not have substantial business activities in the foreign acquirer's jurisdiction. In addition to applying to the acquisition of a U.S. corporation, the proposed anti-inversion rules would also apply to the direct or indirect acquisition of substantially all the assets of a U.S. partnership or substantially all the U.S. trade or business assets of a foreign partnership. These rules would apply to transactions effected after the enactment of the revised rules.

Policies promoting "onshoring" businesses. The administration has proposed a credit equal to 10% of certain qualifying costs incurred in connection with onshoring a trade or business. To be eligible for the credit, taxpayers would be required to reduce a business being conducted outside the United States and start or expand a business in the United States that results in an increase in U.S. jobs. In addition, to further incentivize onshoring and discourage offshoring, deductions for expenses paid in connection with offshoring a U.S. trade or business will be disallowed, including for purposes of calculating the subpart F income and GILTI of CFCs. Credits for onshoring would be available for expenses paid or incurred after enactment.

High-tax income exclusion. The exemption from taxation under the subpart F income rules for certain high-tax income would be eliminated, and the cross-reference to the exemption would be eliminated from the GILTI rules. Removing the cross-reference should put an end to the controversy about certain Treasury regulations that provide a high-tax exemption for GILTI.

Foreign derived intangible income deduction. FDII incentivizes U.S. corporations to sell directly (rather than through a branch or CFC) into foreign countries products and services tied to intellectual property held in the United States. The generous deduction for FDII would be repealed effective for taxable years beginning after December 31, 2021.

Energy and Infrastructure Policies

Clean energy incentives. Among numerous other clean energy proposals, the Budget proposes extending both the "production tax credit" and the "investment tax credit," which generally provide credits for the production of clean energy and investment in clean energy facilities, respectively. Additionally, the proposals include a 30% credit (or cash in lieu of a credit) for investment in qualifying electric power transmission property placed in service after December 31, 2021, and before January 1, 2032. Other incentives being contemplated include providing credits for investments in low-carbon hydrogen as a fuel source, the production of energy at existing nuclear facilities, and the expansion and enhancement of credits for carbon capture facilities.

Energy-efficient buildings. Proposals include extending and enhancing incentives for improving the energy efficiency of existing residences, constructing new energy-efficient homes, and improving the energy efficiency of commercial buildings.

Removal of fossil fuel preferences. The Budget proposes that certain credits, deductions and other special provisions of the Code targeted toward encouraging oil, gas and coal production be eliminated entirely for taxable years beginning after December 31, 2021.

Other Revenue Raisers

Excess business loss limitation. Currently, certain "excess business losses" of non-corporate taxpayers are no longer deductible against taxable income, but are instead carried forward, similarly to a corporate net operating loss (NOL). Excess business losses are losses exceeding the sum of (i) the taxpayer's business gains and (ii) a specified threshold (currently $524,000 for a married couple filing jointly). The Budget proposes making this change permanent. It is currently set to expire in 2027.

Restricting like-kind exchanges. This proposal would limit the ability of taxpayers to defer gain recognition through like-kind exchanges to only $500,000 in a taxable year ($1 million for a married couple filing jointly). Any gain in excess of such amounts realized by taxpayers in like-kind exchanges would be subject to tax. This proposal would be effective for exchanges completed in taxable years beginning after December 31, 2021.

Key Proposals Affecting Individuals

Personal Income Tax Increases

Personal income tax rates. As expected, the Budget proposes returning the top marginal tax rate to the pre-TCJA figure of 39.6% while lowering the thresholds for income subject to this rate. In addition, the Budget proposes that pass-through income of individuals with at least $400,000 of adjusted gross income would become subject to either the 3.8% net investment income tax (NIIT) or the 3.8% *Self-Employment Contributions Act* (SECA) tax.

Capital gain and qualified dividend income. Long-term capital gain and qualified dividends of taxpayers would be taxed at applicable ordinary income tax rates, but only to the extent that the taxpayer's adjusted gross income exceeds $1 million (indexed for inflation after 2022). This proposal would be effective retroactive to the date of announcement – a measure that is intended to prevent taxpayers from selling highly appreciated assets now to avoid those gains being subject to ordinary income tax rates.

Carried interest. The Budget proposes taxing as ordinary income subject to SECA a partner's share of profits from, and gain from the disposition of, "carried interests" held by taxpayers whose taxable income from all sources exceeds $400,000. The proposal also contemplates including anti-abuse rules that are intended to prevent avoidance of this proposed carried interest rule through the use of compensatory arrangements other than partnership interests.

New Gain Recognition Events

Transfers of appreciated property by gift or upon death. As part of its effort to increase tax revenues related to the ownership of capital assets, the administration has proposed that a donor or decedent must recognize unrealized appreciation in certain assets transferred by gift or upon death after December 31, 2021. Transfers of appreciated property to a surviving spouse or a charity would not be recognized and the property would be received with a carryover basis. The proposal contemplates exempting $1 million dollars of such gain per person (adjusted for inflation after 2022), with any unused portion being portable to a surviving spouse, separately continuing to exclude a portion of such gain related to a principal residence, and excluding any such gain inherent in tangible personal property other than "collectibles." Presumably, the exclusion of tangible personal property is to avoid burdening families and the IRS with assessing the value of cars, clothes and other household goods not likely to appreciate, rather than gold and other valuables. These gain recognition rules would also be applied to gratuitous transfers to, and distributions in kind from, a trust, partnership or other non-corporate entity other than a grantor trust effective January 1, 2022. Currently, much of this appreciation escapes income tax in the United States due to the "stepped-up basis" rule that resets the tax basis of assets transferred at death to the FMV of the assets at the time of death. With this change in place, the assets of an estate, along with the unrealized appreciation in such assets, could be subject to upwards of an 80% combined effective federal and state income and estate tax. This may be compared to the maximum 26.5% rate on such assets in Canada's two largest provinces. Income tax on the appreciation of interests in certain "family-owned and -operated" businesses could be deferred until the business is sold or the business is no longer family owned and operated. Tax on appreciation of illiquid assets could be paid under a 15-year fixed-rate payment plan. The IRS may require security from taxpayers to enter into such payment plans. The income tax imposed at death would be deductible in computing amounts subject to estate tax.

Tax on long-unrealized appreciation. The Budget proposes that a trust, partnership or other non-corporate entity that is the owner of property that has not been subject to a recognition event (e.g., sale, exchange or other taxable transfer) in the prior 90 years would be required to recognize as income any appreciation of such assets. The testing period for this proposal would begin January 1, 1940. Accordingly, the first possible recognition event under this rule would occur on December 31, 2030, for assets that have not been subject to a recognition event since January 1, 1940. This may be compared to the 21-year deemed disposition rule in Canada for trusts.

Other Notable Items

IRS Funding

The Budget requests approximately $80 billion of additional mandatory funding for the IRS to improve its collection and enforcement efforts. These efforts are slated to primarily target high-income taxpayers – a group that has recently been subject to a low audit rate due to the complexity and cost of enforcement actions against this group. In addition, the IRS would receive the funding necessary to modernize its technology infrastructure.

Comprehensive Financial Account Reporting

To further aid the IRS in its collection and enforcement efforts, the Budget proposes to expand the scope of mandatory third-party reporting of accounts owned by businesses and individuals. As explained in the Green Book, financial institutions would be required to provide an annual report on gross transfers into and out of accounts. The reports would be required to detail the extent to which such transfers involved physical cash, transactions with foreign accounts and accounts owned by the same taxpayer. The Green Book also notes that similar reporting requirements would be imposed upon cryptocurrency asset exchanges and cryptocurrency custodians. These proposals would be effective for taxable years beginning after December 31, 2022. Although these reports would not directly notify the IRS of gross income in the same way a 1099 does, the information contained within these reports would allow the IRS to discover unreported taxable income, the threat of which may lead to further voluntary compliance efforts by taxpayers currently underreporting their income. The administration estimates that this proposal would generate $462 billion in tax revenue over the next 10 years.

Omissions

Some items previously discussed by President Biden and his administration are conspicuously absent from the Budget. Since many of these omissions relate to provisions that, in the absence of legislation, are scheduled to sunset or revert to pre-TCJA levels in a few years, perhaps the Biden administration determined that it was unnecessary to expend political capital on issues that will be addressed with the passage of time. Specifically there are no proposals to:

- repeal the $10,000 cap on the deduction for state and local property taxes, which several congressional Democrats have stated would be necessary for them to support any tax legislation proposed by the administration.
- repeal the 20% deduction for "qualified business income" of certain pass-through business owners and self-employed individuals, which was a key piece of the TCJA's business tax cuts.
- change the interest deduction limitation rules of section 163(j), which are scheduled to change from 30% of EBITDA to 30% of EBIT in 2022.
- expand the gift and estate tax by raising the estate tax rate or reducing the lifetime exclusion amount. Current law provides for a 40% rate and an $11.7-million lifetime exclusion (scheduled to revert to approximately $6.4 million in 2026).

Conclusion

Although these proposals are just the beginning of the process, they show an ambitious and expansive agenda, certain parts of which are sure to form the basis of the 2022 budget and any tax reforms passed to support the many programs being proposed. Biden is certainly looking to deliver a victory on his campaign promises, which are baked into the Budget. However, it remains uncertain whether Democrats will be able or willing to push through such an expansive and expensive piece of legislation in the face of Republican opposition.

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