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U.S. Tax Laws: A Review of 2021 and a Look Ahead to 2022

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Review of U.S. Tax Developments in 2021

Last year, we predicted that the biggest U.S. tax news in 2021 would be revenue-raising legislation that the Democrats would put forward after the election of Joe Biden as the 46th president of the United States. As we went to press last year, runoff senate elections in Georgia had just given the Democrats a razor-thin majority in both houses of Congress. As a result, many commentators were predicting a revolution in progressive lawmaking that would include a wish list of tax-the-rich revenue raisers.

The Democrats' tax proposals were, in fact, the biggest U.S. tax news this year, but no one could have predicted the way things actually turned out. Initially, the package of tax policies and provisions that would be known as the *Build Back Better Act* (BBBA) looked as expected: The early descriptions of the underlying tax policy raised income tax rates, included new taxes for wealthy individuals, purported to close loopholes in pro-business Trump tax provisions, and even allocated billions of dollars to increase IRS enforcement efforts.

The Democrats, however, seem to have misunderstood how precarious their position was. Generally, in order to avoid a filibuster, at least 60 senators (out of a total 100) must support a legislative bill for it to advance. An exception for "budget reconciliation" bills allows the Senate to pass one bill per year by a simple majority, as long as that bill relates only to spending, revenues or the debt limit. Since the Democrats control only half the seats in the Senate (with Vice President Kamala Harris as the tie-breaker), the BBBA would have to be enacted under the reconciliation procedure. The bottom line was that for the BBBA to pass in the Senate, all of the Democrats would have to support the bill.

This situation provided an opportunity for one or two Democrats to seize power by blockading the entire process. Joe Manchin of West Virginia and Kyrsten Sinema of Arizona withheld the final votes needed to ensure the BBBA's passage, which set off a long process of negotiations and political grandstanding that ultimately led to a much weaker form of the BBBA, which may not result in meaningful legislation at all.

The U.S. tax community was exhausted by the process. Initially, the ambitious new tax provisions in the BBBA promised a re-run of the *Tax Cuts and Jobs Act of 2017* (TCJA), which generated reams of regulations and commentary intended to explain how to apply the new rules. As the fate of the BBBA became clear, however, efforts at statutory interpretation gave way to political speculation. Ultimately, the United States saw little progress in other areas of tax law during 2021.

In fact, the biggest step forward in tax policy during 2021 was in respect of the OECD's base erosion and profit shifting (BEPS) initiative, which has been in development for almost a decade. This year the proponents of BEPS produced several detailed policy statements that advanced the two "Pillars" of the project, which led to more than 130 countries signalling their support for the project to date.

The following discussion reviews U.S. legislative, regulatory and judicial developments in federal and state tax laws. For previous annual tax law reviews, see our 2021 and 2020 bulletins.

Federal Tax Legislation

As noted above, the Biden administration and the U.S. Congress spent 2021 drafting the BBBA, which included a number of tax proposals intended to fund major public investment in American infrastructure. The opposition of Senators Manchin and Sinema to the BBBA, however, caused the policy statements and legislative language to become increasingly less ambitious as the year wore on. The following outline describes the development of the BBBA's tax provisions from ambitious policy proposals to compromised statutory language.

The American Jobs Plan and STEP Act

On March 31, 2021, the Biden administration released the American Jobs Plan (Plan), which proposed $2.3 trillion in infrastructure investment over the next eight years. The tax provisions intended to fund the investment read like a progressive tax policy wish list. Provisions of the Plan that targeted high-net-worth individuals included the following:

- increasing the top marginal tax rate to 39.6%, from 37%, and subjecting qualified dividends and capital gains to ordinary income rates for taxpayers making more than $1 million per year;
- extending the 12.4% social security payroll tax to taxpayers making more than $400,000 per year;
- eliminating the step-up in basis at death;
- increasing the estate tax rate and decreasing the lifetime estate tax exemption.

In connection with the Plan, a group of senators and representatives introduced the *Sensible Taxation and Equity Promotion Act* (STEP Act), which included the following additional provisions that were intended to eliminate certain wealth transfer strategies used by high-net-worth families:

- taxing the built-in gains on lifetime gifts of appreciated property;
- taxing grantor trusts on the unrealized appreciation in their assets every 21 years (like Canada);
- taxing the built-in gains on appreciated property transferred at death, subject to an exemption for the first $1 million and certain exceptions (also like Canada).

The Plan also looked to domestic and international businesses to raise revenue through changes to tax provisions that primarily affect businesses:

- increasing the corporate income tax rate to 28%, from 21%;
- imposing a 15% alternative minimum tax on the book income of corporations with at least $100 million in book income;
- increasing the effective tax rate on global intangible low-taxed income (GILTI) to 21%, and making other changes that would have expanded the applicability of the GILTI regime;
- imposing a 10% surtax on U.S. corporations that "offshore manufacturing and service jobs to foreign nations in order to sell goods or provide services back to the American market";
- eliminating the foreign derived intangible income (FDII) deduction available to U.S. corporations with respect to sales made to foreign buyers of goods and services that are tied to intangible assets (e.g., patents and trademarks) held in the United States;
- repealing the base erosion and anti-abuse tax (BEAT) and implementing an "under-taxed payments rule" to bring the U.S. tax code more in line with Pillar Two of BEPS.

The Green Book

Most of the provisions in the Plan and the STEP Act became part of the Biden administration's budget proposal for 2022, which was released at the end of May. The budget included details of $3.6 trillion in tax increases, which were described in the accompanying Green Book. The Green Book included some additional proposals, including the following:

- taxing carried interest as ordinary income;

- eliminating like-kind exchanges, with certain exceptions;
- expanding the 3.8% net investment income tax.

The Green Book also increased the IRS's funding by almost $80 billion over the next 10 years, mostly earmarked to increase enforcement against taxpayers with an annual income of more than $400,000. In addition, it proposed new reporting regimes applicable to financial accounts and cryptocurrencies.

The Green Book did not include the increase in the estate tax rate and reduction of the lifetime exemption, which was proposed in the Plan.

House Ways and Means Version of the BBBA

Actual legislative language on these policy proposals did not appear until September, when the House Ways and Means Committee released its version of the revenue provisions of the BBBA. Many of the controversial tax proposals from earlier in 2021 were scaled back or even abandoned in the Ways and Means version. The changes included the following:

- Corporate income tax rate would be increased to 26.5%, instead of to 28%.
- Top capital gains and qualified dividends rate would be increased to 25%, instead of to 39.6%.
- Effective tax rate on GILTI would be increased to 16.5625%, instead of to 21%.
- Deduction for FDII would be effectively reduced to 20.7%, instead of being eliminated.
- Elimination of like-kind exchanges would be abandoned.

The Ways and Means version contained a handful of provisions that were not clearly part of previous proposals, such as a 3% "surcharge" on the income of non-corporate filers with more than $2.5 million in annual income (or $5 million for joint filers), and tightened requirements for interest paid to non-U.S. lenders to qualify for the "portfolio interest" exception from withholding.

Some of the policy proposals affecting estate planning made it into the Ways and Means version of the legislation, and others did not. Specifically, the Ways and Means version included a (smaller) reduction in the lifetime exemption, but the increase to the estate tax rate was dropped. The trust-related provisions of the STEP Act and the elimination of the step-up in basis at death were not included, but a new provision appeared that would add any assets held in a grantor trust back into the grantor's estate at death. Finally, the Ways and Means version included a number of new limitations and caps on the amounts that could be contributed to or held in IRAs and certain defined benefit plans.

The Version of the BBBA Passed by the House

In November, the House passed a further revised version of the BBBA that was even more watered down than the Ways and Means version. Specifically, this second version of the tax provisions abandoned the proposed increases to the individual and corporate tax rates altogether (although it retained the 3% surtax on high-income taxpayers), and it failed to include the proposed limitations on grantor trusts and tighter restrictions on carried interests.

By the end of 2021, prospects for meaningful tax reform were dim. Initially, the Democrats had thought they had a blank check to pass whatever tax proposals they liked, but Senators Manchin and Sinema succeeded in taking the edge off the Democrats' razor-thin majority in the Senate.

Federal Administrative Developments

The IRS seems to have finished the most important regulatory projects related to the TCJA. Relatively few significant regulations were released in 2021.

In January, the IRS released final regulations under section 163(j), as amended by the TCJA. This package of regulations was generally consistent with proposed versions of the regulations, but also included clarifications on changes to section 163(j) as part of the COVID-19 relief legislation passed in 2020.

Also in January, the IRS released final rules on the three-year holding period to qualify income with respect to carried interests for capital gain treatment. These regulations were generally consistent with proposed versions of the regulations, although they expanded an exception from the three-year holding period for capital interests in partnerships.

At the end of December, the IRS finalized regulations on foreign tax credits and the application of controlled foreign corporation rules to domestic partnerships. It also proposed rules on passive foreign investment companies, which generally provide an "aggregate" approach to passive foreign investment companies (PFICs) held through partnerships.

Tax Cases

A number of interesting tax cases were heard in 2021. A few highlights follow:

Transfer Pricing Cases Continue. Last year we reported on the IRS's transfer pricing victory in *Coca-Cola v Commissioner*, in which the Tax Court allowed the IRS to proceed with almost $10 billion in transfer pricing adjustments. During 2021, Coca-Cola hired a new team of lawyers, headed by Laurence Tribe of Harvard Law School, but the Tax Court denied the new legal team's motion for reconsideration. Another important transfer pricing case, *Medtronic Inc. v Commissioner*, concerning the appropriateness of adjustments to the comparable uncontrolled transaction method for intercompany patent licences, received a new trial in June, although the opinion has not yet been released. Despite the IRS's successes in these cases, taxpayers are still defending allocation methodologies that push profit into related foreign subsidiaries, particularly in licensing cases. See, for example, *Amgen v Commissioner* and *Zimmer Biomet Inc. v Commissioner*.

Anti-Injunction Act Challenged. *The Anti-Injunction Act* (AIA) prohibits taxpayers from suing the IRS until after the IRS collects a tax (i.e., one cannot enjoin the IRS from collecting a tax prospectively). In *CIC Services LLC v IRS*, a taxpayer sued the IRS to challenge the validity of certain information reporting requirements for captive insurance companies. The IRS argued that the case should be dismissed under the AIA because the IRS had not yet assessed penalties against the taxpayer to enforce the reporting requirements. The Court held that the AIA does not apply to information reporting requirements, because a "reporting requirement is not a tax; and a suit brought to set aside such a rule is not one to enjoin a tax's assessment or collection." This case may open the door to more aggressive litigation by taxpayers against the IRS.

Obamacare Survives. In June, the U.S. Supreme Court dismissed a challenge to the Affordable Care Act (ACA) in *California v Texas*. The plaintiffs in this case argued that the ACA was unconstitutional as a result of Congress reducing the tax penalty for violating the ACA to zero. The Court held that the plaintiffs had no standing to challenge the ACA because they could not show that they were harmed by the law. In addition, the Court stated that it could not prohibit the ACA's enforcement, because the reduction of the tax penalty to zero made the ACA unenforceable. After *California v Texas*, the ACA has withstood multiple judicial challenges, which suggests that the ACA may be here to stay.

Section 280E Upheld. Section 280E disallows federal tax deductions and credits for businesses that consist of trafficking in certain controlled substances prohibited by federal law, such as marijuana. In *San Jose Wellness v Commissioner*, the taxpayer advanced technical arguments that its business did not "consist of" trafficking in controlled substances, because its business included services such as acupuncture and chiropractic. The Tax Court was not convinced, and accordingly *San Jose Wellness* joined a line of cases that support section 280E.

Passport Program Challenged. Since 2015, the U.S. Department of State has had the power to deny or revoke an individual's U.S. passport if the IRS certifies under section 7345 that the individual has seriously delinquent tax debt. In *Maehr v U.S. Department of State*, the Tenth Circuit heard a case in which the government ordered a taxpayer to surrender his passport because of taxes and penalties from 2003 through 2006 totalling approximately $250,000. The taxpayer challenged the order, claiming that the government action violated his constitutional right to travel. The Tenth Circuit became the first appellate court to join several lower courts in upholding the constitutionality of section 7345 and its related revocations of U.S. passports.

Update on Tax Treaties

After tax treaties with Japan, Luxembourg, Spain and Switzerland were ratified in 2020, no further action on tax treaties was seen in 2021. Treaties with Chile, Hungary and Poland are still pending because of concerns that those treaties are inconsistent with the U.S. BEAT rules.

State-Level Developments

One of the most controversial provisions of the TCJA was its limitation of the federal deduction for state and local taxes to $10,000. This "SALT cap" is widely regarded as political punishment for high-tax "blue" states that generally vote for Democrats in presidential elections. Many tax commentators speculated that the Democrats' tax legislation in 2021 would roll back the SALT cap, but no proposal materialized.

Even though no federal relief appeared, many states in 2021 advanced legislation designed to allow at least some taxpayers to effectively deduct state taxes despite the SALT cap. Generally, these provisions work by allowing a pass-through entity to pay a special entity-level tax on income that is passed through to the entity's owner. This results in a reduction in the owner's federal taxable income, because the IRS generally taxes income allocated from a pass-through entity on a net basis (i.e., after the allocation is reduced for expenses such as entity-level taxes). The state then allows the owner to take a tax credit against his or her own state tax liability to reflect the owner's share of the entity-level tax.

In late 2020, the IRS issued Notice 2020-75, which approved of this kind of SALT cap work-around. Since then, at least 20 states have enacted pass-through entity taxes, including New York, California, Connecticut and New Jersey.

International Developments Affecting the United States

The OECD's BEPS project made progress in 2021, with over 130 countries (including the United States) signing on to a revised "framework" for Pillars One and Two of the project on July 1, 2021. Additional details and an implementation plan were released in October. The development of the framework during 2021 is definitely a step forward, although much work remains to be done.

One factor motivating the agreement on the Pillars may be the proliferation of digital services taxes. Some large Internet companies structure their affairs so that much of their income escapes taxation under traditional tax nexus rules that are based on physical presence in the taxing jurisdiction. Some countries have adopted the policy that a company that benefits from that country's consumers should not be able to escape taxation on the resulting income from the country. Accordingly, certain countries have adopted or proposed unilateral digital services taxes, which claim taxing jurisdiction over companies based on a company's economic activity in a particular country, even if the company has no physical presence there.

Pillar One would provide modern nexus standards intended to capture income generated from a country that would otherwise escape taxation by that country. Many countries have promised to roll back their digital services taxes once Pillar One goes into effect.

At the beginning of 2021, the Biden administration signalled its support of the Pillars when Treasury Secretary Janet Yellin changed the Treasury Department's negotiating position to allow some of the largest U.S. companies to be subject to the new rules. This change in approach could reflect a hope that implementing the Pillars will cause some countries to do away with their digital services taxes, which are widely seen as targeted at U.S. multinational companies.

Significant changes would be needed in U.S. tax law for it to be consistent with the Pillars. Pillar One would require the United States to cede taxing jurisdiction to countries with the relevant markets, at least for the largest U.S.-based multinationals. Janet Yellin has indicated a willingness to do this, but the BBBA did not include any provisions that would be relevant to Pillar One.

Pillar Two presents a number of challenges for U.S. tax law.

- **The BEAT.** The United States currently subjects large corporate groups to a minimum rate of tax if cross-border payments to related parties exceed more than 3% of the company's total deductions. This is inconsistent with Pillar Two's "undertaxed payments rule," which denies a deduction (or requires some other adjustment) when one group member makes a deductible payment to a second group member that is resident in a low-tax jurisdiction (unless Pillar Two's "income inclusion rule" applies). The policy statements that preceded the BBBA would have replaced the BEAT with "the SHIELD," which conformed more closely with the undertaxed payments rule. The actual legislative text of the BBBA, however, would have left the BEAT unchanged.
- **GILTI.** Under current law, the minimum effective tax rate on GILTI is 10.5%, which is below the 15% agreed minimum corporate tax rate in Pillar Two. The effective GILTI tax rate is scheduled to increase in 2026, but until then the U.S. GILTI rate is too low for Pillar Two. Some other aspects of the GILTI rules are also inconsistent with Pillar Two, such as the exclusion of QBAI (qualified business asset investment) from GILTI.
- **Soak-Up Taxes.** The current GILTI rules include a limitation on foreign tax credits, which is intended to discourage low-tax jurisdictions from raising their tax rates to "soak-up" tax revenue that the United states would otherwise collect. If the U.S. GILTI rules were changed to conform to Pillar Two, they would have to contend with the extent to which taxes paid to low-tax jurisdictions would be creditable.
- **Dispute Resolution.** Pillar Two requires countries to coordinate highly complex tax systems based on an international standard. Controversies are sure to arise. Historically, the United States has been hesitant to submit to the kind of international arbitration that would be necessary to resolve those disputes.
- **Passage.** Possibly the most daunting challenge for the United States to conform to Pillar Two would be making these changes happen if the Senate withholds its approval. If the Republicans regain their majority in the Senate after the midterm elections later this year, there may not be much support for the Pillars in Congress.

A handful of these changes made it into the BBBA – for example, the BBBA would have raised the rate of income tax on GILTI to more than 15% and would have replaced the BEAT with the SHIELD, a new regime aligned with Pillar Two's undertaxed payments rule. Now that the BBBA has been all but abandoned, it is unclear whether these provisions will make it into new tax legislation.

U.S. Tax Development Outlook for 2022

U.S. tax news in 2021 was dominated by the unexpected opposition of Senators Manchin and Sinema to some of the central policy objectives of the Biden administration, including the tax provisions of the BBBA. At the beginning of 2021, the Democrats' slim majority in the Senate was widely acknowledged, but no one could have predicted that members of the Democrats' own party would stand in the way of the party's goals.

Senator Manchin has gone on record saying that the BBBA is "dead." There is some talk in Washington that some of the BBBA provisions could be revived. President Biden even used his State of the Union speech in early 2022 to advocate for several tax provisions of the BBBA, such as increasing the tax burden on taxpayers making more than $400,000 per year, and adopting the minimum tax provisions and the changes to make the GILTI regime consistent with Pillar Two. The midterm elections are likely to occupy legislators' attention beginning in the summer, so any action on the BBBA provisions would have to be underway by April at the latest.

Other than that, the crystal ball reveals only shadows. Certain regulatory projects are expected, such as final regulations on qualified foreign pension funds under section 897(l). Beyond that, the midterm elections make the future too hazy for most prognosticators. Will the Republicans gain seats and go back to the business-friendly tax agenda of the Trump years? Or will the Democrats cling to their majority and salvage some fragments of their shattered tax policy? Check in with us next year for the answers.

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