Biden Administration's Green Book Proposes Significant Changes to Tax Regime

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On May 28, 2021, the Treasury Department released the General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals (sometimes called the Green Book) to accompany President Joe Biden's proposed budget for FY 2022. If enacted, the Green Book proposals would significantly increase tax burdens on corporate and individual taxpayers and make sweeping changes to the international tax regime that was overhauled in 2017 by the Tax Cuts and Jobs Act (TCJA). The proposals also would significantly impact planning for transfers of wealth by treating transfers by gift and at death as realization events for income tax purposes. Also, in line with the Biden administration's policy goals related to renewable energy, the Green Book sets forth numerous proposals to expand tax benefits favoring clean energy and rescind tax incentives currently available with respect to fossil fuels.

Treasury officials have described the Green Book as a "conceptual" document providing a starting point for discussions with Congress. Prior to the enactment of any new tax legislation, the Treasury Department may build upon the Green Book by modifying or abandoning some of these proposals or offering new ones (including, for example, modifying or repealing Section 199A). Below, we provide a brief description of certain noteworthy proposals in the Green Book (including commentary from Treasury officials) and offer our observations.

Corporations

Increase Corporate Income Tax Rate: As anticipated, the Biden administration would increase the corporate income tax rate from 21% to 28%, in line with Obama-era proposals but well under the 35% rate in place prior to the TCJA. By far the largest revenue-raiser in the Green Book, this would increase the tax cost of engaging in taxable corporate transactions and increase the economic value of tax attributes that are tied to the corporate rate, such as net operating losses (NOLs) and disallowed interest carryforwards. This new rate is not retroactive to 2021, and the Green Book does not describe any anti-abuse rules related to the timing of income and other tax items. Taxpayers may wish to consider strategies to accelerate recognition of income and built-in gains into 2021 and defer otherwise deductible costs and expenses into 2022 or beyond.

Introduce 15% Minimum Tax on Book Income: Corporate taxpayers with worldwide book income in excess of $2 billion would have to compute a "book minimum tax" by subtracting their regular corporate income tax liability from a book tentative minimum tax (BTMT). The BTMT would be equal to 15% of worldwide pre-tax book income minus (1) book NOL deductions, (2) general business credits (including research and development, clean energy and housing tax credits) and (3) foreign tax credits (FTCs).

Book income tax credits (BITCs) generated by positive book income tax liability could be carried forward to offset regular tax in future years to the extent regular tax exceeds BTMT in those future years. Like the carryforward mechanism for the former corporate alternative minimum tax, these BITCs could mitigate the harm of uneven income realization, though firms could suffer costs related to the time value of money (a dollar today is worth more than a dollar tomorrow), and it is not guaranteed that firms will be able to perfectly "smooth out" their tax liability through BITCs (if FTCs expire unused, for example).

A primary reason for significant book-tax disparities for certain large public companies is their use of deductible stock-based compensation. This proposal could have especially powerful effects on such companies, as well as on large capital-intensive businesses that use bonus depreciation and immediate expensing to reduce or eliminate their regular corporate income tax liability.

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This proposal is vague in many respects. It is unclear, for example, (1) how book NOLs are computed; (2) whether there is a limited carryforward period for book NOLs and BITCs; (3) whether book NOLs and BITCs would be subject to limitations like those in Sections 382 and 383; (4) whether other country-by-country proposals or existing FTC limitations would limit the availability of certain FTCs for this purpose; and (5) the applicability of other concepts when tax treatment and accounting treatment differ.

New Limitation on Interest Deductions: In general, each U.S. corporation or group of U.S. corporations (a "subgroup") that is part of a financial reporting group (generally, a multinational group that prepares consolidated financial statements, including one with a non-U.S. parent) would be required to limit its interest deductions to (1) its "proportionate share" of the entire group's interest expense, determined based on income, or (2) if it fails to substantiate its proportionate share or so elects, its interest income plus 10% of its adjusted taxable income (ATI), as defined under Section 163(j). Disallowed interest expense and excess limitation could be carried forward indefinitely. The proposed limitation would apply concurrently with Section 163(j) — whichever limit is lower is the limit that would apply.

Treasury officials have confirmed that this proposal is not intended to apply to U.S.-parented financial reporting groups consisting solely of the parent and its CFCs. In that respect, this proposal resembles older proposals from the Obama and George W. Bush administrations.

This proposal would not apply to financial services entities (FSEs), though it is not clear how this exclusion would apply in practice. The Green Book would grant Treasury broad authority to fulfill the purposes of this proposal, including providing a (new) definition of "financial services entity." The Green Book also states that FSEs "are excluded from the financial reporting group for purposes of applying the proposal to other members of the financial reporting group," which suggests that even if the FSE rules of Section 904 are incorporated (in whole or in part), the financial services group (FSG) rules will not be — that is, an FSG will not be entirely excluded from this rule, but an entity that does not qualify as an FSE on a stand-alone basis will be subject to the rules.

International

Major Changes to GILTI: The Biden administration proposes substantial changes to the global intangible low-tax income (GILTI) regime that was created by the TCJA, including:

1. reducing the Section 250 deduction from 50% to 25%, resulting in a GILTI rate of 21% (*i.e.*, 75% of the proposed 28% corporate rate);
2. eliminating the 10% exemption for qualified business asset investment (QBAI);
3. calculating the Section 904 FTC limitations for GILTI income (the "GILTI basket") and foreign branch income (the "branch basket") on a country-by-country basis;
4. applying a similar country-by-country approach to tested losses;
5. repealing the "high-tax exception" for both GILTI and Subpart F; and
6. eliminating the "tested income exception" for foreign oil and gas extraction income.

The elimination of the QBAI exemption and the high-tax exception would push the U.S. further away from a territorial system of international taxation and toward a worldwide system in which a business's income is taxed by the country in which that business is located.

The proposal is intended to encourage the enactment of a multilateral global minimum tax regime negotiated with the OECD ("Pillar Two") by taking into account (on a country-by-country basis) any taxes paid by a U.S. corporation's non-U.S. parent under an "income inclusion rule," providing relief for "sandwich" structures in which a non-U.S. parent owns a U.S. subsidiary with CFCs. It is important to note that the proposed 21% GILTI rate is higher than the 15% global minimum rate the Biden administration has indicated it could accept in OECD negotiations. Moreover, there is no indication that Treasury would reduce or eliminate the 20% "haircut" for GILTI basket FTCs. As a result of these provisions, the effective foreign tax rate that one would have to pay to avoid GILTI could be as high as 26.25%. This rate is substantially higher than any global minimum tax rate likely to result from OECD negotiations.

The country-by-country approach for GILTI and branch basket FTCs would be a sea change in international taxation, eliminating most planning opportunities that rely on a "cross-crediting" strategy. Firms with an international footprint may be compelled to make allocations to dozens of GILTI and branch baskets in addition to their baskets for general and passive income. The country-by-country approach would be especially onerous in the GILTI context; unlike the branch basket, the GILTI basket does not allow carryforwards or carrybacks of excess credits. Though this was not explicitly stated in the Green Book, Treasury officials have indicated that they intend to use this country-by-country approach to sequester tested losses in their countries of origination, preventing multinational firms from offsetting tested income arising in one country with a tested loss

arising in another. Fortunately for taxpayers, there is no indication that cross-crediting will be constrained for 2021, allowing for tax planning this year in anticipation of any changes.

Expand Section 265 Disallowance of Deductions: This proposal would extend Section 265 — which disallows deductions allocable to certain tax-exempt income — to deductions allocable to a class of foreign income that is taxed at a preferential rate or not at all, including the Section 250 deduction for a portion of GILTI income and the Section 245A deduction for certain dividends. This would replace Section 904(b)(4), which treats deductions as if they were disallowed solely for purposes of the FTC calculation.

The Green Book does not indicate how deductions would be allocated to the income targeted by this proposal. If done in accordance with existing allocation regulations, the disallowance of these deductions would be particularly onerous for taxpayers with significant interest expense and high-tax CFCs with substantial GILTI income. It is also unclear how this proposal would interact with existing rules for allocating interest for foreign tax credit purposes under existing regulations.

In a footnote, the Green Book states that this proposal is not intended to create any inferences regarding current law, including whether Section 265 currently disallows such deductions. Though the mere mention of this controversial position could signal Treasury's interest in considering it as a regulatory matter, the substance of this footnote suggests that any regulations attempting to implement the proposal are likely to be purely prospective.

Tighten Inversion Rules: U.S. corporations and certain partnerships that redomicile outside the United States in a merger or acquisition with a non-U.S. corporation would be treated as U.S. corporations if more than 50% of the final entity is held by former shareholders of the initial entity. Even if continuity is 50% or less, the final entity will be treated as domestic if (1) the domestic corporation's fair market value is greater than the foreign acquiring corporation's fair market value immediately before the combination; (2) the combined entity is managed and controlled in the U.S., and (3) the "expanded affiliated group" does not have substantial business activities in its new jurisdiction.

This is a major shift in the operation of Section 7874, which imposes special rules on inversions in which initial shareholders acquire 60-79% of the final company but does not alter the non-U.S. status of that final company. Instead, the new Section 7874 would act as an on/off switch, imposing domestic status on each company produced by international mergers as long as shareholders of the U.S. entity own more than 50% of that final company. This switch may be flipped even where there is significantly less than 50% U.S. shareholder continuity if the various exceptions, add-backs and other adjustments in the existing regulations are retained in their current form. Strikingly, it appears possible that the alternative "managed and controlled" test could apply even where there is zero U.S. shareholder continuity, as in a debt-financed all-cash acquisition of a larger U.S. corporation by a smaller non-U.S. corporation that is managed and controlled in the United States. It is unclear whether such a test would be consistent with current income tax treaties.

These new rules could also change the definition of "domestic entity acquisition" to apply on a business-line-by-business-line basis. For example, the new Section 7874 could ensnare a non-U.S. corporation's acquisition of substantially all of the assets of a trade or business of a U.S. corporation (as opposed to substantially all of the U.S. corporation's total assets, as is required under current law). The term "trade or business" could be construed very broadly, creating substantial uncertainty and high costs for taxpayers. For example, this proposal would appear to apply the inversion rules to any carve-out or asset sale by a U.S. corporation of a division or even product line to a non-U.S. corporation. The proposal also would appear to prevent a U.S. corporation from spinning off (even taxably) one of its businesses into a non-U.S. corporation, except in the very rare case where the substantial business activities test is satisfied.

There does not appear to be any grandfathering for deals that have signed but not yet closed. If this proposal becomes law, companies wishing to invert will face serious pressure to close any outstanding deals.

Repeal FDII: The Green Book would repeal the deduction available to U.S. corporations on their foreign-derived intangible income (FDII). The Green Book states that "resulting revenue will be used to encourage R&D" but provides no concrete details.

Replace BEAT With SHIELD: The Base Erosion and Anti-abuse Tax (BEAT) introduced by the TCJA would be replaced by the Stopping Harmful Inversions and Ending Low-tax Developments (SHIELD) rule, which denies deductions for certain payments made to members of the same financial reporting group in "low-taxed" jurisdictions starting in 2023. SHIELD would apply to the cost of goods sold (COGS) by remedially disallowing "other deductions (including unrelated party deductions)" instead of payments for COGS itself.

SHIELD is meant to work in tandem with the proposed GILTI rules and a new OECD regime for taxing multinational companies; the definition of a "low-taxed" jurisdiction is determined in reference to Pillar Two of the OECD plan or, if there is no agreement on Pillar Two, the GILTI rate (*i.e.*, 21% under the administration's proposal). The effective tax rate for each financial group member also would be derived from Pillar Two principles, which would require the disaggregation of financial statements on

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a jurisdiction-by-jurisdiction basis. Unlike Pillar Two, the Biden administration's proposal disallows deductions in their entirety, rather than merely to the extent that a low-taxed jurisdiction's tax rate is lower than a global minimum rate. Treasury officials have indicated that this is an intentional feature of the plan designed to encourage countries to adopt Pillar Two.

In some respects, SHIELD is far broader in application than BEAT, applying to any multinational group with global consolidated revenue greater than $500 million, even if the group has a relatively small presence in the United States. In other respects, SHIELD is narrower than BEAT. For example, Treasury officials have made it clear that SHIELD should not apply to U.S.-based multinational corporations with respect to their CFCs, provided that other international tax proposals are adopted. Treasury would have broad authority under this proposal to create exceptions for such firms, as well as non-U.S.-parented multinational corporations in countries that have adopted Pillar Two, investment funds, pension funds, international organizations and other nonprofit entities.

Introduce On-Shoring and Off-Shoring Incentives: The Green Book provides a business credit for "reducing or eliminating a trade or business (or line of 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 this results in an increase in U.S. jobs." It also denies deductions for expenses related to moving jobs out of the United States. These proposals lack key details, including (1) specific requirements for attaining the business credit, (2) how to measure a business activity's impact on U.S. jobs, and (3) how these incentives avoid violating any WTO and state aid rules.

Expand Scope of Section 338(h)(16): This proposal would apply the principles of Section 338(h)(16) to U.S. shareholders who recognize gain in connection with a change of entity classification (for example, via a "check-the-box" election) or on a sale of a "hybrid" entity treated as a corporation for non-U.S. tax purposes but as a partnership or disregarded entity for U.S. tax purposes. This would cause the source and character of any item resulting from such transactions to be determined as if the seller sold or exchanged stock for FTC purposes. This would generally conform the treatment of a "check and sell" transaction with the treatment of a sale of corporate stock subject to a Section 338 election.

The effect of this proposal might be limited if the country-by-country proposals described above are enacted. As noted, those proposals would limit the utility of cross-crediting strategies, which would make the transactions targeted by this proposal less appealing in general. For example, the sale of a CFC with a Section 338 election in a country-by-country FTC regime would be much less likely to give rise to a Section 951A inclusion offset by excess credits.

Individuals

Increase Top Individual Rate: The top rate for individual taxpayers would increase from 37% to 39.6%. The number of people subject to this top rate also would increase due to the application of the top rate to income over $452,700 ($509,300 for married taxpayers filing jointly), as compared to $523,601 ($628,301 for married taxpayers filing jointly) in 2021. Notably, the Green Book deviates from President Biden's campaign proposals by omitting any revival of the Pease limitation or other policies that would reduce the value of itemized deductions.

Tax Capital Gains as Ordinary Income: Currently taxed at preferential rates, long-term capital gains and qualified dividend income would be taxed at ordinary income rates for taxpayers whose income exceeds $1 million ($500,000 for married taxpayers filing separately), indexed for inflation after 2022. While this proposal was previously announced during President Biden's campaign and widely expected, the Treasury Department surprised observers by imposing this rate increase on "gains required to be recognized after the date of announcement," which is widely believed to mean April 28, 2021 (the date of the announcement of the American Rescue Plan). It remains to be seen whether the retroactive effective date will survive the legislative process, though there is reason to believe that Congress may not defer to Treasury's recommendation. In any event, full repeal or partial rollback of the rate preference for long-term capital gains and qualified dividend income would have profound ramifications for individual taxpayers, compounding the incentives to defer realization events for appreciated investments, increasing the economic value of capital losses and capital loss carryforwards, and bringing dividend-bearing equity investments closer to tax parity with interest-bearing debt investments.

Tax Carried Interests as Ordinary Income: Taxpayers with taxable income over $400,000 who perform services for an "investment partnership" and hold a profits interest in such partnership (an "investment services partnership interest") must pay tax at ordinary rates and self-employment taxes on their allocable share of income from that interest and on gains from the sale of that interest. A partnership is an investment partnership if (1) substantially all of its assets are investment-type assets (certain securities, real estate, interests in partnerships, commodities, cash or cash equivalents, or derivative contracts with respect to those assets), and (2) over half of the partnership's contributed capital is from partners in whose hands the interests constitute property not held in connection with a trade or business.

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If the proposed repeal of the long-term capital gain preference is enacted, the effect of the carried interest proposal is likely to be limited. It would only affect taxpayers who have annual income between $400,000 and $1 million and earn at least some of that income from a profits interest in a certain kind of partnership; few people are likely to meet these criteria. In contrast, if the long-term capital gain preference survives, even in a limited form (for example, if the rate on capital gains increases to 30%), this proposal would have a significant impact on the tax treatment of carried interests and optimal planning strategies for many partnerships.

Treat Transfers of Appreciated Property by Gift or at Death as Realization Events: In what would be a transformational change to existing law, donors and decedents would generally recognize gain on appreciated property transferred by gift or at death. The tax on gain realized at death would be deductible on the decedent's estate tax return. The extent to which losses could be recognized is unclear, as is the extent to which a decedent's loss carryovers could offset gains realized at death.

There are limited exclusions from gain recognition, including a $1 million exclusion per donor or decedent and exclusions for transfers to charities and U.S. spouses who take transferred property with a carryover basis. The payment of tax on illiquid assets transferred at death may be made based on a 15-year fixed-rate payment plan, and the payment of tax attributable to certain family-owned and operated businesses could be deferred until the business is sold or ceases to be family-owned and operated.

Transfers of property to and distributions of property from irrevocable trusts, partnerships and other noncorporate entities also would be treated as recognition events. In addition, trusts, partnerships and other noncorporate entities that own property must recognize gain on unrealized appreciation of that property if the property has not been subject to a recognition event in 90 years, starting January 1, 1940 — in other words, the first taxable events under this aspect of the proposal would happen on December 31, 2030.

Imposing tax on contributions of appreciated property to partnerships and on distributions of appreciated property from partnerships goes far beyond the elimination of basis step-up at death and, taken at face value, would upend longstanding principles of partnership taxation, such as Sections 721 and 731. Treasury officials have since indicated that this proposal was not intended to have such a broad impact. It therefore seems safe to assume that the application of this proposal to partnerships would be significantly limited or omitted altogether in future legislation.

Imposing income tax on transfers of appreciated property to trusts and on distributions of appreciated property from trusts, including many grantor trusts, could reduce the attractiveness of certain estate planning trusts, such as grantor retained annuity trusts (GRATs), and could have broad-ranging, perhaps unintended, consequences for common trust transactions (*e.g.*, the distribution of property from a trust to a beneficiary or from one trust to another upon the happening of a particular event).

The value of property subject to tax on a gift, death or other triggering event would generally be determined in accordance with estate and gift tax valuation principles, except that a "partial interest" in property would have a value equal to its proportionate share of the fair market value of the entire property. It is not clear what property would be considered a "partial interest" for this purpose.

Harmonize and Expand SECA and NIIT: The Green Book proposes to subject all pass-through business income of taxpayers with at least $400,000 of adjusted gross income to either the net investment income tax (NIIT) or Self-Employment Contributions Act (SECA) tax. To that end, the NIIT base would expand to include income and gain from trades or businesses not otherwise subject to employment taxes. In addition, certain S corporation owners, limited partners and LLC members who provide services and "materially participate" in their businesses would be subject to the SECA tax on distributive shares above certain thresholds, subject to current-law exceptions for certain types of income (*e.g.*, rents, dividends, capital gains and certain retired partner income). The Green Book defines "materially participate" to mean regular, continuous and substantial involvement and says that this will "usually" mean at least 500 hours spent on the business per year. This is similar to the "500 hour" standard in the passive loss rules but not an explicit requirement. In short, these provisions would make it very difficult for high-income taxpayers who are partners in operating partnerships and provide services to those partnerships to avoid paying at least 3.8% on top of their typical income tax rates.

Limit Nonrecognition in Like-Kind Exchanges: The Green Book would limit eligibility for "like-kind" exchanges under Section 1031. Each taxpayer would be allowed to defer up to $500,000 of gain each year ($1 million for married taxpayers filing jointly) for like-kind exchanges of real property. Gains in excess of that amount would be recognized in the taxable year when the taxpayer transfers the real property. These changes would require REITs to distribute gains on property sales that could otherwise be deferred under Section 1031. Given timing rules under Section 1031 and the proposal's application to exchanges

completed in taxable years beginning after December 31, 2021, this proposal may pick up many exchanges *beginning* in 2021.

Make Excess Loss Disallowance Permanent: The Section 461(l) disallowance of excess business losses for noncorporate taxpayers in taxable years would be made permanent.

Energy

The Green Book proposes to extend and expand several existing clean energy tax incentives. In particular, both the Section 48 investment tax credit for solar, offshore wind and other eligible property and the Section 45 production tax credit for wind and other qualified facilities would be extended in full for applicable property or facilities the construction of which begins after 2021 and before 2027, with the credit then phasing out linearly over the following five years based on the commencement of construction date for the applicable property or facility. Also, the Section 48 investment tax credit would be expanded to include stand-alone storage with a capacity exceeding 5 kWh. To enhance the Section 45Q carbon oxide sequestration credit, the Green Book would extend the credit's commencement of construction deadline by five years (to the end of 2030) and provide additional credits of $35 per metric ton of carbon oxide captured from hard-to-abate industrial carbon oxide capture sectors that is disposed of in secure geological storage and, for direct air capture products, an additional $70 per metric ton for qualified carbon oxide disposed of in secure geological storage.

The Green Book also proposes to authorize an additional $10 billion of credits under Section 48C for investments in eligible property used in a qualifying advanced energy manufacturing project, which also would be expanded to include more eligible technologies, including energy storage and components, electric grid modernization equipment, carbon oxide sequestration and energy conservation technologies. The previously-authorized $2.3 billion of credits under Section 48C were all allocated by the end of 2013. The Green Book also sets forth proposals for new clean energy incentives, including a credit equaling 30% of a taxpayer's investment in qualifying electric power transmission property placed in service after 2021 and before 2032, including overhead, submarine and underground transmission facilities meeting certain criteria.

Each of these credits would include a direct pay option, allowing the credit to be treated as equivalent to a payment of tax that would be refundable to the extent it exceeds taxes otherwise payable. In that way, the taxpayer does not need tax capacity in order to currently benefit from the credit. The Green Book is unclear as to whether the direct pay amount would be equal to the full amount of the credit otherwise claimable or would be "hair cut" in a way similar to the proposed GREEN Act (H.R. 848), which generally would allow for a direct payment of 85% of the credit otherwise claimable. The Green Book also provides that each tax incentive would be paired with "strong labor standards." The proposed GREEN Act includes a labor standards proposal, which may provide a blueprint for what the administration is considering.

The effect of these proposals on clean energy financing and investment transactions is unclear. The inclusion of the direct pay option may make it possible for certain developers to forego tax equity investments in favor of self-funding or in favor of debt financing (including short-term bridge financing secured by the future tax refund and/or long term project financing). However, if the direct pay option includes a haircut, then tax equity might be a more efficient choice, particularly if the developer cannot otherwise currently utilize depreciation deductions from the project or interest deductions from the debt. A developer also would have to assess the availability and cost of debt financing.

Perhaps notable is that the proposals in the Green Book do not appear to align with the approach taken in Sen. Ron Wyden's recently proposed Clean Energy For America Act (S. 1288). That proposal seeks to consolidate existing tax incentives for clean energy into technology-neutral benefits that would phase out based on reductions in annual greenhouse gas emissions in the United States instead of time periods or dollar amounts. Given that significant divergence, and other recent public statements from policymakers about federal support for infrastructure, it is difficult to gauge the likelihood that these Green Book proposals in favor of clean energy would be enacted.

In addition to instituting or expanding these benefits for clean energy, the Green Book proposes repealing several existing incentives available to companies in the fossil fuels industry. In particular, the Biden administration would eliminate:

1. credits for costs attributable to qualified enhanced oil recovery projects and oil and gas produced from marginal wells;
2. full expensing of intangible drilling costs and exploration and development costs;
3. the deduction for costs paid for tertiary injectant used as part of a tertiary recovery method;
4. the exception to passive loss limitations provided to working interests in oil and natural gas properties;
5. the use of percentage depletion with regard to oil and gas wells, as well as hard mineral fossil fuels;
6. the availability of two-year amortization of independent producers' geological and geophysical expenditures (increased to seven years);

7. the corporate income tax exception for publicly traded partnerships with qualifying income and gains from activities relating to fossil fuels (effective for taxable years beginning after December 31, 2026);
8. taxation at long-term capital gains rates for royalties received on the disposition of coal or lignite;
9. the exemption from the Oil Spill Liability Trust Fund excise tax for crude oil derived from bitumen- and kerogen-rich rock; and
10. accelerated amortization for air pollution control facilities.

The Biden administration also would reinstate and increase excise taxes on (1) domestic crude oil and on imported petroleum products; (2) listed hazardous chemicals; and (3) imported substances that use as materials in their manufacture or production one or more of the hazardous chemicals subject to the excise tax described in (2).

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