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Treasury’s Green Book Provides Details on the Biden Administration’s Tax Plan

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On May 28, 2021, the Biden Administration released the Fiscal Year 2022 Budget, and the “General Explanations of the Administration’s Fiscal Year 2022 Revenue Proposals,” which is commonly referred to as the “Green Book.” The Green Book summarizes the Administration’s tax proposals contained in the Budget. The Green Book is not a proposed legislation and each of the proposals will have to be introduced and passed by Congress.

The Green Book proposes to:

- Increase in the corporate tax rate to 28% from 21%. However, recent news reports suggest that President Biden may be willing to agree to maintain the corporate tax rate at 21%.[1]
- Increase in the top individual tax rate to 39.6% from 37%.
- Substantially change the international tax rules, as previously proposed in the Made in America Tax Plan (which was part of the American Jobs Plan) and summarized here.
- Impose a 15% minimum tax on the book earnings of certain large corporations.
- Increase the long-term capital gains rate and qualified dividend income rate to 39.6% (43.4% including the net investment income tax) from 20% (23.8% including the net investment income tax (“NIIT”)) to the extent the taxpayer’s income exceeds $1 million, indexed for inflation. This proposal is proposed to be effective **retroactively** for gains and income recognized after April 28, 2021.
- Treat death and gifts of appreciated property as realization events that require gain to be recognized as if the underlying property was sold, subject to a $1 million lifetime exclusion. Gains on gifts or bequests to charity would not be required to be recognized, and gains on gifts or bequests to a spouse would not be required to be recognized until the spouse dies or disposes of the asset, but basis would carry over.

- Treat all pass-through business income of high-income taxpayers as subject either to the 3.8% NIIT or the 3.8% Medicare tax under the Self-Employment Contributions Act ("SECA"). Accordingly, limited partners who provide services would be subject to self-employment tax on their distributive share of the partnership's business income, and S corporation shareholders who materially participate in the corporation's trade or business would be subject to SECA taxes on their distributive share of the S corporation's business income to the extent it exceeds certain thresholds.
- Treat income from carried interests as ordinary income that is subject to self-employment tax.
- Impose a $500,000 per person limit ($1 million in the case of married individuals filing a joint return) on the aggregate amount of section 1031 like-kind exchange gain deferral for each year, with any excess recognized in the year of the exchange.
- Make permanent the excess business loss limitation.
- Mandate a comprehensive financial account information reporting regime beginning in 2023 that would require gross inflow and outflow reporting for all bank and other financial accounts with a gross flow threshold of $600 or a fair market value of $600.

Increase the Top Marginal Rate for Individuals and the Corporate Rate

The Green Book would increase the top individual income tax rate to 39.6% (from 37%) for taxable income over $509,300 for married individuals filing a joint return, $452,700 for unmarried individuals (other than surviving spouses), $481,000 for head of household filers, and $254,650 for married individuals filing a separate return. For years after 2022, the thresholds would be indexed for inflation using the C-CPI-U. The proposal would be effective for taxable years beginning after December 31, 2021.

Consistent with the proposal in the Made in America Tax Plan, the Green Book would increase the income tax rate for C corporations from 21% to 28%. The proposal would be effective for taxable years beginning after December 31, 2021. For taxable years beginning after January 1, 2021 and before January 1, 2022, only the portion of the taxable year in 2022 would be subject to the 28% rate. (However, as noted above, recent news reports suggest that President Biden may be willing to agree to maintain the corporate tax rate at 21%.)

Significant Changes to the International Tax Rules

GILTI

The “global intangible low-taxed income” (“GILTI”) regime generally imposes a 10.5% minimum tax on 10-percent U.S. corporate shareholders of “controlled foreign corporations” (“CFCs”) based on the CFC’s “active” income in excess of a threshold equal to 10% of the CFC’s tax basis in certain depreciable tangible property (this basis, “qualified business asset investment,” or “QBAI”).[2] GILTI is not determined on a country-by-country basis, and, therefore, under current law a U.S. multinational corporation may be able to avoid the GILTI tax with respect to its CFCs operating in low tax-rate countries by “blending” income earned in the low tax-rate countries with income from high tax-rate countries. In addition, income that is subject to a foreign effective tax rate in excess of 90% of the U.S. corporate income tax rate generally is excluded from GILTI.

Effective Tax Rate on GILTI

Under the Green Book (as under the prior Made in America Tax Plan), the effective tax rate on GILTI for corporate taxpayers would increase from 10.5% to 21%, which represents an increase in the effective tax rate on GILTI to 75% of the corporate tax rate (21%/28%) from 50% of the corporate tax rate under current law (10.5%/21%).

Country-by-Country Determination

Today, GILTI is applied on a global basis and U.S. multinationals can avoid the GILTI tax on investments in low-tax jurisdictions by “blending” the income earned by CFCs in low-tax jurisdictions with income earned in high-tax jurisdictions. The Green Book (as the prior Made in America Tax Plan) would require GILTI to be determined on a country-by-country basis that would prevent blending. Accordingly, income earned in low tax-rate countries would be subject to the minimum tax under the GILTI regime.

Elimination of 10% of QBAI exclusion

The Green Book (as the prior Made in America Tax Plan) proposes the elimination of the exclusion of 10% of QBAI from the GILTI calculation. Accordingly, the first dollar of CFC “active” income would be subject to the GILTI tax.

Repeal of the High-Tax Exception from GILTI

The Green Book (but not the prior Made in America Tax Plan) proposes to repeal the high-tax exception from GILTI.

FDII

The "foreign-derived intangible income" ("FDII") regime provides a lower 13.5% effective tax rate for certain foreign sales and the provision of certain services to unrelated foreign parties in excess of 10% of the taxpayer's domestic QBAI.

The Green Book (like the prior Made in America Tax Plan), would repeal FDII.[3]

BEAT

The "base erosion and anti-abuse tax" ("BEAT") generally provides for an add-on minimum tax, currently at 10%, on certain deductible payments that are made by very large U.S. corporations to related foreign parties.

The Green Book (as the prior Made in America Tax Plan) would replace the BEAT regime with the "Stopping Harmful Inversions and Ending Low-tax Developments" or "SHIELD" regime. Similar to the BEAT, the SHIELD regime would also deny U.S. multinationals tax deductions for payments made to related parties, but only if the related parties receiving the payments are subject to a low effective rate of tax. The tax rate at which the SHIELD regime is triggered would initially be equal to the 21% proposed GILTI rate,[4] but would be replaced by an eventual global minimum tax rate established under OECD BEPS project's Pillar Two.[5]

The SHIELD regime would only 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.

Expansion of Anti-Inversion Rules

An inversion transaction is typically a transaction in which the shareholders of an existing U.S. corporation own that corporation as a subsidiary of a non-U.S. corporation. Statutory anti-inversion provisions under section 7874, together with additional guidance provided in the Treasury regulations, subject the foreign acquirer and/or the inverting U.S. corporation to a number of potentially adverse tax consequences. If the continuing ownership stake of the shareholders of the inverted U.S. corporation is 80% or more, the foreign acquirer is treated as a U.S. corporation for U.S. federal income tax purposes. If the continuing ownership stake of the shareholders of the inverted U.S. corporation is between 60% and 80%, certain rules designed to prevent “earnings stripping” – or deductible payments by the U.S. corporation to its foreign parent – apply.

The Green Book would expand the anti-inversion rules in many significant ways. These proposals were outlined in the Made in America Tax Plan, but the Green Book contains significantly more detail. First, the Green Book proposes to replace the 80% threshold with a 50% threshold, and to eliminate the separate regime that applies to inverted U.S. corporations with a continuing ownership level between 60% and 80%. Accordingly, under the Green Book, if a non-U.S. corporation acquires a U.S. corporation and 50% or more of the historic shareholders of the U.S. corporation own the non-U.S. corporation, the non-U.S. corporation would be taxable as a U.S. corporation.

Furthermore, the Green Book proposes an additional category of transactions that would be treated as inversion transactions that cause the acquiror to be treated as a U.S. corporation, without regard to the level of shareholder continuity: if a non-U.S. corporation acquires shares in a U.S. corporation and (1) immediately prior to the acquisition, the fair market value of the domestic target entity is greater than the fair market value of the foreign acquiring corporation, (2) after the acquisition, the “expanded affiliated group” (generally, a group of corporations related through at least 50% of ownership) is primarily managed and controlled in the United States, and (3) the expanded affiliated group does not conduct substantial business activities in the country in which the non-U.S. acquiring corporation is created or organized, then the non-U.S. acquiring corporation would be taxable as a U.S. corporation.

Finally, the Green Book would expand the scope of anti-inversion rules to cover acquisitions of substantially all of the assets constituting (i) a trade or business of a U.S. corporation or partnership, or (ii) a U.S. trade or business of a non-U.S. partnership and distributions of stock in a foreign corporation by a domestic corporation or a partnership that represent either substantially all of the assets or substantially all of the assets constituting a trade or business of the distributing entity.

15% Minimum Tax on Book Income for Certain Large Corporations

The Green Book (as the prior Made in America Tax Plan) proposes a 15% minimum tax on certain large corporations based on their book income. The Green Book clarifies certain aspects of this 15% minimum tax. The book income minimum tax would apply only to corporations with worldwide book income in excess of $2 billion, and would be reduced by general business credits (including R&D, clean energy and housing tax credits) and foreign tax credits. This tax is structured as a minimum tax, and therefore, would apply only if it exceeds the corporation's regular income tax. The 15% minimum book income tax is effective for taxable years beginning after December 31, 2021.

Taxing Capital Gains at Ordinary Income Rates for High-Income Earners

The Green Book proposes (as did the earlier American Families Plan) taxing long-term capital gains and qualified dividends of taxpayers with adjusted gross income of more than $1 million (indexed for inflation after 2022) at the applicable ordinary income tax rates, which generally would be 39.6% (43.4% including the net investment income tax).

The Green Book proposes that this increase in the long-term capital gains and qualified dividend income tax rates be retroactive and be applied to income recognized after "the date of announcement", which is April 28, 2021.

If the proposal to increase the tax rate of capital gains is enacted, we would expect taxpayers to defer sales of appreciated property and to use cashless collars and prepaid forward contracts to reduce economic exposure, and to monetize, liquid appreciated positions. We would also expect an increase in tax-free mergers and acquisitions.

Gift Transfer and Death as Realization Events

Under current law, transfer by gift or death is not taxable, and upon death, the decedent's heirs get a "stepped up basis" to fair market value at the time of death. Under the proposal in the Green Book, death and gifts of appreciated property would be treated as realization events that require gain to be recognized as if the underlying property was sold, subject to a $1 million ($500,000 for married couples filing separately) lifetime exclusion, which would be indexed for inflation after 2022. Gains on gifts or bequests to charity would not be required to be recognized, and gains on gifts or bequests to a spouse would not be required to be recognized until the spouse dies or disposes of the asset. Basis would carry over in each case.

Payment of tax on the appreciation of certain family-owned and operated businesses would not be due until the interest in the business is sold or the business ceases to be family-owned and operated. The Green Book proposal would also allow a 15-year fixed-rate payment plan for the tax on appreciated assets transferred at death, other than (i) liquid assets, such as publicly traded financial assets, and (ii) businesses for which the deferral election is made.

The proposal would tax transfers of property into, and distributions in kind from, a trust, partnership or other non-corporate entity (other than a grantor trust that is deemed to be wholly owned and revocable by the donor). It is questionable whether the drafters intended as broad a result as the words of the proposal suggest because it would effectively prohibit the use of partnerships for many common business ventures.

Finally, the Green Book proposal would apparently impose tax without any realization event on the unrealized appreciation of assets of a trust, partnership or other non-corporate entity if there has not been a recognition event with respect to the applicable property within the prior 90 years, beginning on January 1, 1940. Accordingly, these entities would be subject to tax with respect to this property beginning on December 31, 2030.

The qualified small business stock ("QSBS") rules of section 1202 would remain in effect.

The proposed rules would be effective after December 31, 2021.

3.8% Medicare Tax for All Trade or Business Income of High-Income Taxpayers

Under the current rules, a 3.8% NIIT is imposed on net investment income (generally, portfolio and passive income) of individuals above a certain income threshold, and a 3.8% Medicare tax under SECA is imposed on self-employment earning of certain high-income taxpayers. Limited partners and S corporation shareholders generally are not subject to the SECA Medicare tax on their distributive share of income from the partnership or the S corporation, respectively.

The Green Book proposes to impose a 3.8% tax (which will be used to fund Medicare), either through the NIIT or SECA Medicare tax, on all trade or business income of taxpayers with adjusted gross income in excess of $400,000.[6]

In addition, limited partners, LLC members and S corporation shareholders who traditionally have not been subject to SECA tax on their distributive share of income from the underlying entity would be subject to SECA tax if they provide services and/or materially participate in the underlying trade or business. Material participation standards appear to be similar to the same standards for purposes of passive activity rules under section 469, which require the person to work for the business for at least 500 hours per year.

The proposal would be effective for taxable years beginning after December 31, 2021.

Carried Interests Give Rise to Ordinary Income

Under current law, a “carried” or “profits” interest in a partnership received in exchange for services is generally not taxable when received and the recipient is taxed on their share of partnership income based on the character of the income at the partnership level. Section 1061 requires certain carried interest holders to satisfy a three-year holding period – rather than the normal one-year holding period – to be eligible for the long-term capital gain rate.[7]

Under the Green Book, a partner’s share of income on an “investment services partnership interest” (an “ISPI”) in an investment partnership would generally be taxable as ordinary income, and gain on the sale of an ISPI would be taxable as ordinary income if the partner’s taxable income (from all sources) exceeds $400,000.

The Green Book defines an ISPI as “a profits interest in an investment partnership that is held by a person who provides services to the partnership”. This definition is broader than section 1061, which applies to interests in partnerships in the business of “raising or returning capital” and investing or developing certain investment-type assets.[8]

Under the Green Book, a partnership will be considered an “investment partnership” if substantially all of its assets are investment-type assets (which are similar to the “specified assets” definition of section 1061), but only if more than 50% of the partnership’s contributed capital is from partners to whom the interests constitute property not held in connection with a trade or business.

The purpose and meaning of the exception provided by this 50% test is unclear. Assume that insurance companies contribute cash from their reserves to an investment partnership in exchange for partnership interests, and the general partner of that partnership receives a carried interest in exchange for managing the assets of the partnership. The partnership interests received by the insurance companies would appear to be reserves held in connection with their trade or business of providing insurance. It appears that the general partner would not be subject to the Green Book proposal or, as discussed below, section 1061, and therefore could receive allocations of long-term capital gain based upon a one-year holding period.

Under the Green Book, if a partner who holds an ISPI also contributes “invested capital” (generally money or other property, but not contributed capital attributable to the proceeds of any loan or advance made or guaranteed by any partner or the partnership or a related person) and holds a qualified capital interest in the partnership, income attributable to the invested capital, including the portion of gain recognized on the sale of an ISPI attributable to the invested capital, would not be subject to recharacterization. “Qualified capital interests” generally require that (a) the partnership allocations to the invested capital be made in the same manner as allocations to other capital interests held by partners who do not hold an ISPI and (b) the allocations to these non-ISPI holders are significant. The “same manner” requirement would be a return to the language used in the section 1061 proposed regulations, which was ultimately relaxed to a “similar manner” requirement in the final regulations.[9] The Green Book’s requirement that allocations to non-ISPI holders be “significant” is also a divergence from the final section 1061 regulations, which look to whether the capital contributed by “Unrelated Non-Service Partners” is significant.[10]

The Green Book would also require partners to pay self-employment tax on ISPI income.

In addition, under an anti-abuse rule of the proposal, any person above the income threshold who performs services for any entity (including entities other than partnerships) and holds a “disqualified interest” in the entity is subject to tax at “rates applicable to ordinary income” on any income or gain received with respect to the interest. A “disqualified interest” is defined as convertible or contingent debt, an option, or any derivative instrument with respect to the entity (but does not include a partnership interest, stock in certain taxable corporations, or stock in an S corporation). Thus, under this proposal if an employee received a note as compensation from a C corporation, any gain on the sale of the note would be taxable at ordinary income rates (but, apparently, would not be treated as ordinary income so the gain could be offset by capital losses). The anti-abuse rule provides that capital gain subject to it is taxable “at rates applicable to ordinary income,” but does not provide that the capital gain is ordinary income. It is unclear why this rule is different than the rule that applies to ISPIs, but it would allow capital losses of the taxpayer to offset the capital gains.

The proposal notes that it is not intended to adversely affect qualification of a REIT owning a profits interest in a real estate partnership.

The proposal would repeal section 1061 for taxpayers whose taxable income (from all sources) exceeds $400,000 and would be effective for taxable years beginning after December 31, 2021. Taxpayers whose taxable income is $400,000 or less would be subject only to section 1061. If the proposal were to become law, we expect that sponsors of funds will be more likely to receive their compensation in the form of deferred fees rather than as a carried interest.

The Green Book proposal appears to be based on the Carried Interest Fairness Act of 2021, the February 2021 House bill (the “House Bill”) introduced by Bill Pascrell (NJ) and co-sponsored by Andy Levin (Michigan) and Katie Porter (California).

Like the Green Book proposal, the House Bill contained provisions to treat the net capital gain with respect to an investment services partnership interest as ordinary income, with a carve out for gain attributable to a partner’s qualified capital interest.[11] The House Bill also subjects income from an investment services partnership interest to self-employment taxes.

The House Bill contains a narrower version of the exception from ISPI contained in the Green Book. Whereas the Green Book proposal exempts an ISPI if not more than 50% of the partnership's contributed capital is from partners to whom the interests constitute property not held in connection with a trade or business, the House Bill would require 75% of a partnership's capital to be attributable to qualified capital interests constituting property held in connection with a trade or business of its owner for the interest to be exempted.

The House Bill would also amend section 83 to currently tax partnership interests transferred in connection with the performance of services, would exempt income from investment services partnership interests from treatment as qualifying income of a publicly traded partnership,[12] would exempt certain family partnerships from the application of the bill, and would increase the penalty for tax underpayments resulting from failure to treat income from an investment services partnership interest as ordinary income. These provisions do not appear in the Green Book proposal.

If the Green Book proposal is enacted, we would expect fund managers increasingly to receive their compensation in the form of deferred fees rather than carry, and to subject the deferred fees to a "substantial risk of forfeiture" to avoid application of sections 409A and 457A.

Repeal of Section 1031 Like-Kind Exchanges

Under section 1031, taxpayers may defer gain on exchange of real property for other real property without any limitation on the amount of deferral.[13] The Green Book proposes to impose a $500,000 per person limit ($1 mm in the case of married individuals filing a joint return) on the aggregate amount gain deferral for each year, with any excess recognized in the year of the exchange.

The proposal would be effective in taxable years beginning after December 31, 2021.

If the proposal is enacted, we would expect an increased use of "UPREIT" structures for transfers of real property, whereby a taxpayer with appreciated property contributes that property to a partnership owned by a real estate investment trust (a "REIT") in exchange for an interest in that partnership that may be converted into an interest in the REIT.

Excess Business Loss Limitation Made Permanent

Section 461(l) generally disallows non-corporate taxpayers from deducting "excess business losses." Excess business losses are losses from business activities in excess of the sum of gains from business activities and specified threshold amount. These losses are carried forward to subsequent taxable years as net operating losses.

The Green Book proposes to make permanent the excess business loss limitation on non-corporate taxpayers, which otherwise would have sunset after December 31, 2026.

Comprehensive Financial Account Information Reporting Regime

The Green Book also proposes a comprehensive financial account information reporting by financial institutions and other similar institutions. This proposal calls for reporting of data on financial accounts, including gross inflows and outflows with a breakdown for cash, transactions with a foreign account and transfer to and from another account with the same owner. Payment settlement entities, custodians and crypto asset exchanges would be subject to similar reporting requirements. The proposal also provides for additional reporting requirements for purchase/transfer of crypto assets. The only exception specified in the proposal is for de minimis amounts at a $600 threshold.

This proposal is proposed to be in effect for tax years beginning after December 31, 2022.

Additional Funding To Be Provided for Enforcement and Tax Administration

The Green Book also proposes an increase in the budget for the IRS Enforcement and Operations Support accounts by $6.7 billion and to provide the IRS with $72.5 billion in mandatory funding, a portion of which would be used for IRS enforcement and compliance. The proposal would direct that these additional resources be used only for enforcement against taxpayers with income above $400,000.

No Repeal of the Cap on Social Security Taxes

Under current law, employers and employees are each subject to a 6.2% social security tax (for a total of 12.4%) and self-employed individuals are subject to a 12.4% social security tax on their first $142,800 (in 2021) of wages. It had been reported that the Biden Administration would lift the cap so that the social security tax applied to all wages and self-employment income. This proposal was not in the Green Book (or the American Families Plan).

No Change to the Gift and Estate Taxes

The Green Book (and the American Families Plan) does not propose any change to the gift and estate taxes.

No Repeal of the SALT Limitation

Currently, only a maximum of $10,000 annually of state and local taxes (“SALT”) are deductible from federal income. The Green Book (and the American Families Plan) does not propose to change the SALT limitation.

[1] Kristina Peterson, Andrew Restuccia and Richard Rubin. “*Biden Signals Flexibility on Taxes for Infrastructure*” Wall Street Journal, June 3, 2021. https://www.wsj.com/articles/bidens-latest-infrastructure-offer-1-trillion-11622725783?page=1

[2] Under section 250, the 10.5% rate is provided through a 50% deduction, which is generally not available for non-corporate taxpayers unless an election under section 962 is made. All section references are to the Internal Revenue Code of 1986, as amended.

[3] A proposal by the Senate Finance Committee would retain FDII, but make several significant changes to it.

[4] The 21% rate would notably treat the U.K. corporate income tax rate (currently at 19%) as being a low effective tax rate for purposes of the SHIELD regime.

[5] The Organisation for Economic Co-operation and Development’s (“OECD’s”) “Pillar Two Blueprint” is a set of rules that would require large multinationals to pay a minimum amount of tax, regardless of where they are organized or do business. On June 5, 2021, the Group of Seven (“G-7”) nations agreed that businesses should pay a minimum tax rate of at least 15% in each of the countries in which they operate. Paul Hannon, Richard Rubin and Sam Schechner. “G-7 Nations Agree on New Rules for Taxing Global Companies”. Wall Street Journal, June 5, 2021. https://www.wsj.com/articles/g-7-nations-agree-on-new-rules-for-taxing-global-companies-11622893415?page=1

[6] The Green Book does not include a proposal to remove the cap on Social Security tax on taxpayers with adjusted gross income in excess of $400,000, which is one of the proposals President Biden had made during his presidential campaign.

[7] Section 1061(a).

[8] Section 1061(c).

[9] Final Treas. Reg 1.1061-3(c)(3)(ii).

[10] Final Treas. Reg 1.1061-3(c)(3)(iv). Under the regulations, Unrelated Non-Service Partners will be treated as having made significant aggregate capital contributions if they possess 5% or more of the aggregate capital contributed to the partnership at the time the allocations are made.

[11] Carried Interest Fairness Act of 2021, H.R. 1068, 117th Cong. (2021).

[12] A "publicly traded partnership" with less than 90% passive "qualifying income" is taxable as a corporation for federal income tax purposes.

[13] Prior to the Tax Cuts and Jobs Act, section 1031 also applied to like-kind exchanges of personal property. The Tax Cuts and Jobs Act limited the scope of section 1031 to like-kind exchanges of real property.

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