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Summary of the Biden Administration???s Fiscal Year 2023 Green Book Tax Proposals

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On March 28, 2022, the Biden Administration released the Fiscal Year 2023 Budget, and the "General Explanations of the Administration's Fiscal Year 2023 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.

Summary of the Green Book's Significant Changes to Current Law:

Business taxation

- ???Increase the corporate income tax rate from 21% to 28%

Individual taxation

- ???Impose a 20% minimum tax on individuals who have more than $100 million in assets
- ???Treat death as a realization event

International taxation

- ???Enact a 15% minimum "undertaxed profits rule" (a "UTPR") to replace the "Base Erosion Anti-Abuse Tax" ("BEAT"), and a 15% "qualified domestic minimum top-up tax" (a "QDMTT"). These proposals are intended to comply with "Pillar Two" – the "Global Anti-Base Erosion" ("GloBE") rules – of the "Inclusive Framework on Base Erosion and Profit Shifting" ("BEPS"), agreed to by the OECD/G20 member states on October 8, 2021.[1]
- ???Increase the "Global Intangible Low-Taxed Income" ("GILTI") rate from 10.5% to 20%
- ???Provide a 10% tax credit for expenses incurred in "onshoring" and deny deductions for "offshoring" a U.S. trade or business

- ???Authorize the IRS to issue regulations to allow taxpayers to make retroactive "qualified electing fund" ("QEF") elections for their "passive foreign investment companies" ("PFICs") without requesting IRS consent

Cryptocurrency taxation

- ???Apply securities loan rules to digital assets
- ???Apply the mark-to-market rules to digital asset dealers and traders
- ???Require information reporting for digital asset transactions

Taxation of investments in real property

- ???Restrict deferral of gain for like-kind exchanges under section 1031
- ???Treat 100% of depreciation recapture on the sale of section 1250 property as ordinary income

Partnership taxation

- ???Tax carried interests as ordinary income
- ???Prevent basis shifting by related partners
- ???Include the 3.8% Medicare tax and self-employment taxes in the centralized partnership audit regime.

Private Foundation Taxation

- ???Limit use of donor advised funds ("DAFs") to avoid private foundation payout requirement

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I. Business Taxation

Increase the Corporate Tax Rate from 21% to 28%

The Biden Administration proposed to increase the corporate income tax rate from 21% to 28%. For calendar year taxpayers, proposal would be effective for taxable years beginning after December 31, 2022. For fiscal year taxpayers with taxable years ending between January 1, 2022 and December 31, 2023, the corporate tax rate would equal 21% plus 7% multiplied by the portion of the taxable year that occurs in 2023. This proposal was also made by the Biden Administration in the Fiscal Year 2022 Green Book.

II. Individual Taxation

The Biden Administration proposed a 20% minimum tax on individuals who have more than $100 million in assets. The minimum tax would be based on all economic income (which the proposal refers to as "total income"), including unrealized gain. The tax would be effective for taxable years beginning after December 31, 2022. The minimum tax would be fully phased in for taxpayers with assets of $200 million or more.

Under the proposal, an individual's 2023 minimum tax liability would be payable in nine equal annual installments (e.g., in 2024-2032). For 2024 and thereafter, the minimum tax liability would be payable in five annual installments. The tax may be avoided by giving away assets to section 501(c)(3) organizations (including private foundations or donor advised funds) or 501(c)(4) organizations before the effective date of the legislation so as to avoid the $100 million threshold.[2]

The Biden proposal is an attempt to address some criticisms of Senator Ron Wyden's (D-Or.) mark-to-market proposal.

The five-year payment period is an attempt to address concerns that Wyden's proposal might overtax volatile assets, and to "smooth" taxpayers' cash flows without the need for the IRS to issue refunds. Under the Biden Administration's proposal, installment payments of the minimum tax may be reduced to the extent of unrealized losses.

The minimum tax is being described as a "prepayment" that may be credited against subsequent taxes on realized income. This description provides a backup argument on constitutionality: the minimum tax isn't a tax on unrealized income but is merely a prepayment of tax on realized income.

Operation of the Minimum Tax.

The minimum tax would apply to taxpayers with wealth (assets less liabilities) in excess of $100 million. The proposal does not define liabilities, and does not indicate whether a taxpayer would be deemed to own the assets of his or her children, or trusts. Therefore it is unclear as to whether a taxpayer who is close to the $100 million threshold may avoid the tax by giving away assets to children. As mentioned above, a taxpayer can give assets to section 501(c)(3) or 501(c)(4) organizations to avoid the threshold, and so, if the minimum tax is enacted, donations to charity would be expected to dramatically increase.

The proposal phases in for taxpayers with wealth between $100 million and $200 million. The phase in is achieved mechanically by reducing the tax liability to the extent that the sum of (w) the minimum tax liability, and (x) the uncredited prepayments exceeds two times (y) the minimum tax rate, times (z) the amount by which the taxpayer's wealth exceeds $100 million. Thus, for a taxpayer with $150 million of wealth and a zero basis and no prior prepayments, the $30 million of minimum tax liability would be reduced by $10 million to equal $20 million. ($10 million is amount by which (x) $30 million exceeds (y) $20 million, which is 40% [two times the minimum tax rate] times $50 million [the amount by which the taxpayer's wealth exceeds $100 million].)

A taxpayer subject to the minimum tax would make two calculations: Their "normal" tax liability under our current realization system, and the "minimum" tax under the proposal. Tax would be paid on the greater of the two.

For purposes of the 20% minimum tax, the taxpayer would include all unrealized gain on "tradeable assets." The proposal does not define tradeable assets. Tradeable assets would be valued using end-of-year market prices. The taxpayer would also include all unrealized gain on "non-tradeable assets." Non-tradeable assets would be valued using the greater of (i) the original or adjusted cost basis, (ii) the last valuation event from investment (i.e., a round of equity financing), (iii) borrowing (i.e., a lender's appraisal), (iv) financial statements, or (v) other methods approved by the IRS. Original or adjusted cost basis would be deemed to increase at a rate equal to the five-year Treasury rate plus two percentage points. The five-year Treasury rate is currently 2.76% and so, at today's rates, non-traded assets without a valuation event would deemed to increase in value at a 4.76% annual rate. The proposal would not require valuations of non-tradeable assets.

While a taxpayer would be subject to the minimum tax if it exceeds the normal tax, as mentioned above, payment of the minimum tax would be made in equal annual installments (nine for the first year of minimum tax liability and five thereafter).

So, assume that a taxpayer purchases an equity interest in a non-traded C corporation on January 1, 2023 for $200 million. The taxpayer has no realized income and no other assets. The taxpayer would have zero “normal” tax. Assume that the five-year Treasury rate is 2.76%. The investment would be deemed to increase in value by 4.76% (to $209.5 million). The minimum tax would be 20% of $9.5 million, or $1.9 million. If this was the taxpayer’s first year subject to the minimum tax, the minimum tax liability would be $211,111 in each of years 2024-32, subject to the “illiquid exception” described below. If the taxpayer subsequently sells the C corporation, it would credit the minimum tax prepayments against his or her income tax liability.

Payments of the minimum tax would be treated as a prepayment available to be credited against subsequent taxes on realized gains.

The Biden Administration has separately proposed that death would give rise to a realization event. If a taxpayer’s prepayments in excess of tax liability exceed gains at death, the taxpayer would be entitled to a refund. The refund would be included in a single decedent’s gross estate for estate tax purposes. Net uncredited used prepayments of a married decedent would be transferred to the surviving spouse (or as otherwise provided in regulations).

In contrast to Senator Wyden’s proposal, which does not require that tax be paid on unrealized gain for non-traded assets, and instead imposes a deferral charge upon realization, the Biden Administration’s proposal generally requires that minimum tax be calculated with respect to all unrealized gain, including deemed appreciation on non-traded assets, subject to an “illiquid exception.” If tradeable assets held directly or indirectly make up less than 20% of a taxpayer’s wealth, the taxpayer may elect to include only unrealized gain in tradeable assets in the calculation of their minimum tax liability. A taxpayer that makes this election would be subject to a deferral charge upon realization to the extent of gain, but the deferral charge would not exceed 10% of unrealized gain. The proposal does not indicate the rate of the deferral charge.

This aspect of the Biden Administration's proposal provides a meaningful benefit to "illiquid" taxpayers and encourages taxpayers to become "illiquid" to qualify for the exception. The proposal provides that tradeable assets held "indirectly" are treated as owned by the taxpayer for this purpose and therefore it is unclear whether and to what extent taxpayers can contribute tradeable assets into nontradeable vehicles to qualify for the illiquid exception. The proposal would provide the IRS with specific authority to issue rules to prevent taxpayers from inappropriately converting tradeable assets to non-tradeable assets.

Estimated tax payments would not be required for minimum tax liability, and the minimum tax payments would be excluded from the prior year's tax liability for purposes of computing estimated tax required to avoid the penalty for underpayment of estimated taxes.

The tax is expected to affect 20,000 taxpayers (in contrast to roughly 700 under Wyden's plan) but to generate approximately the same amount of revenue as Wyden's proposal: $360 billion over ten years as estimated by the Treasury Department (which is expected to be around $550 billion over 10 years under the Joint Committee on Taxation's "scoring" methodology).

III. International Taxation

A. Enact a UTPR and a QDMTT to Replace the BEAT

Background: The OECD/G20 agreement.

On October 8, 2021, the OECD and G20 countries agreed to subject multinational parent companies to an IIR and a UTPR.

The OECD/G20 UTPR acts as a backup to the IIR. It provides that if the parent of a multinational group is not subject to the IIR top-up tax, deductions will be denied to the other members of the group (or their taxes will otherwise be adjusted) to produce a 15% effective rate of tax in each taxing jurisdiction in which a member of the parent's group does business.

In December 2021, the OECD/G20 allowed countries to adopt a QDMTT. A QDMTT is a domestic minimum tax that is computed using the same rules as the OECD/G20's IIR and UTPR. If a country adopts a QDMTT, that country has first priority to claim top-up taxes for foreign subsidiaries whose effective rate is less than 15%. Effectively, adopting a QDMTT prevents other countries from denying deductions to group members.

Under the OECD/G20 rules, nonrefundable credits reduce a company's effective rate of tax and may subject the company to a UTPR. In the United States, most tax credits are nonrefundable, and, therefore, this rule was particularly controversial.

The OECD/G20 rules provide the following formula to calculate how the IIR top-up tax is divided among those countries that have adopted a UTPR:

50% x (number of employees in a country applying the UTPR/number of employees in all UTPR countries), plus 50% x (total net book value of tangible assets in a country applying the UTPR/total net book value of tangible assets in all UTPR countries).

The UTPR Proposed by the Biden Administration.

The Biden Administration would replace the BEAT with a UTPR that is consistent with the OECD/G20's UTPR. The UTPR proposed by the Biden Administration would apply to both domestic corporations that are part of the non-U.S. group and U.S. branches of non-U.S. corporations. Under the Biden Administration's UTPR, these entities would be disallowed U.S. tax deductions to the extent necessary to collect the hypothetical amount of top-up tax required for the financial reporting group to pay an effective tax rate of at least 15% in each foreign jurisdiction in which the group has profits.[3]

Profit and effective tax rate for a jurisdiction would be based on the group's consolidated financial statements, with certain adjustments, rather than taxable income. In addition, the computation of a group's profit for a jurisdiction would be reduced by an amount equal to 5% of the book value of tangible assets and payroll with respect to the jurisdiction.[4]

The proposed UTPR would apply to non-U.S. multinationals that have global annual revenue of $850 million or more in at least two of the prior four years. The UTPR would not apply to a group's profit in a jurisdiction if the three-year average of the group's revenue in the jurisdiction is less than $11.5 million and the three-year average of the group's profit in the jurisdiction is less than $1.15 million. Finally, the UTPR would not apply to a group with operations in no more than five jurisdictions outside of the group's primary jurisdiction and the book value of the group's tangible assets in those jurisdictions is less than $57 million. This exception would expire five years after the first day of the first year in which the UTPR otherwise would apply to the group.

The deduction disallowance would apply pro rata with respect to all otherwise allowable deductions, and it would apply after all other deduction disallowance provisions. To the extent that the UTPR disallowance for a taxable year exceeds the aggregate deductions otherwise allowable to the taxpayer for that year, the excess amount of the UTPR disallowance would be carried forward indefinitely until an equivalent amount of deductions are disallowed in future years.

A coordination rule would reduce the UTPR disallowance imposed by the United States to reflect any top-up tax collected by members of the group in accordance with the OECD/G20 UTPR (a "qualified UTPR") in one or more other jurisdictions. With respect to each financial reporting group, the percentage of top-up tax allocated to the United States would be determined by the following formula where a jurisdiction applies a qualified UTPR:

US allocation = 50% × Number of employees in the U.S./Number of employees in all OECD/G20 jurisdictions + 50% × Total book value of tangible assets in the U.S./Total book value of tangible assets in all OECD/G20 jurisdictions.

This formula matches the OECD/G20 version.

The QDMTT Proposed by the Biden Administration

To ensure that the U.S. has taxing priority over other countries that have enacted a UTPR, the Biden Administration has also proposed to enact a QDMTT. The QDMMT would equal the excess of (a) 15% of the financial reporting group's U.S. profit, using the same rules as under the UTPR to determine the group's profits for a jurisdiction, over (b) all the group's income tax paid or accrued with respect to U.S. profits (including state income taxes, corporate alternative minimum tax, and creditable foreign income taxes incurred with respect to U.S. profits).

The Biden Administration's proposal provides, without explanation, that U.S. taxpayers would benefit from tax credits and other incentives (apparently despite the fact that they are nonrefundable and would normally reduce the effective rate of tax under the OECD/G20 agreement).

The proposals to replace the BEAT with the UTPR and QDMTT would be effective for taxable years beginning after December 31, 2023.

B. Increase GILTI Rate to 20%

Under current law, the GILTI regime generally imposes a 10.5% minimum tax on 10% U.S. corporate shareholders of "controlled foreign corporations" ("CFCs"), based on the CFC's "active" income that exceeds a threshold of 10% of the CFC's tax basis in certain depreciable tangible property (this basis, "qualified business asset investment" or "QBAI"). At present, a U.S. shareholder's GILTI inclusion is calculated on an aggregate basis. Accordingly, U.S. multinational corporations blend income and losses from low-tax jurisdictions with income and losses from high-tax jurisdictions, potentially avoiding the GILTI tax on the earnings of subsidiaries in low-tax jurisdictions.

The Biden Administration has proposed to increase the GILTI rate from 10.5% to 20%, in conjunction with an increase in the corporate tax rate from 21% to 28%. Moreover, the Biden Administration has proposed to apply GILTI on a jurisdiction-by-jurisdiction basis to prevent blending.

C. Onshoring Tax Credit/Offshoring Loss of Deductions

To encourage U.S. employers to bring offshore jobs and investments back to the United States, the Biden Administration has proposed a new general business credit of 10% of the eligible expenses paid or incurred in onshoring a U.S. trade or business. Onshoring a U.S. trade or business is defined as (a) reducing or eliminating a business or line of business currently conducted outside the U.S. and (b) starting up, expanding or otherwise moving the same trade or business within the United States, to the extent that this would increase U.S. jobs.

To discourage U.S. employers from moving U.S. jobs offshore, the Biden Administration has proposed to (a) disallow deductions for expenses paid or incurred in connection of offshoring and (b) deny deductions for a U.S. shareholder's GILTI or Subpart F income inclusions for any expenses paid or incurred in connection with offshoring. Offshoring is defined as (a) reducing or eliminating a trade or business or line of business currently conducted in the United States and (b) starting up, expanding or otherwise moving the same trade or business outside the United States, to the extent that this would lead to a loss of jobs in the United States.

D. Expand Access to Retroactive QEF Elections

A PFIC is a foreign corporation with primarily passive income or passive assets, whose shareholders are not subject to the CFC rules. Under the PFIC rules, gain realized on the disposition of stock of a PFIC is treated as an "excess distribution," which is included in the shareholder's gross income as ordinary income and gives rise to an additional tax in the nature of a penalty based on the interest rate that applies to tax underpayments. PFIC shareholders that make a QEF election can avoid this additional tax on excess distributions and instead pay tax on their pro rata share of the PFIC's ordinary income and long-term capital gains.

Under current law, a PFIC shareholder is entitled to make a QEF election (or protective election) for a taxable year at any time on or before the due date such shareholder must file its tax return; however, to the extent permitted by regulations, a shareholder may make a late, or retroactive, QEF election if the shareholder reasonably believed that the company was not a PFIC. A PFIC shareholder that has failed to timely make a QEF election or protective QEF election can make a retroactive QEF election only if (a) the shareholder relied on a qualified tax professional's advice; (b) the U.S. government's interests are not be prejudiced by granting consent; and (c) the shareholder requests special consent before the issue is raised on audit.

The Biden Administration has proposed to eliminate the requirement that a shareholder must have relied on a qualified tax professional's advice and the requirement that a shareholder must have sought special consent. Instead, the IRS would be authorized to permit a taxpayer to make a retroactive QEF election without requesting consent, so long as the election would not prejudice the U.S. government. In addition, the IRS would be authorized to permit partnerships and other non-individual taxpayers that inadvertently fail to make a QEF election to do so retroactively.

IV. Cryptocurrency Taxation

The Biden Administration proposed certain very limited changes to the taxation of cryptocurrency transactions. The proposals do not change the current treatment of cryptocurrency as property for federal income tax purposes, and do not address any of the fundamental tax issues that cryptocurrency raise.

A. Apply Securities Loan Rules to Digital Assets

Under current law, securities loans that satisfy certain requirements are tax-free under section 1058.[5] The Biden Administration's proposal would expand section 1058 to apply to "actively traded digital assets" recorded on cryptographically secured distributed ledgers, so long as the loan agreement contains similar terms to those currently required for loans of securities. [6] The Secretary would also have the authority to define "actively traded" and extend section 1058 to "non-actively traded" digital assets. In addition, the proposal would require a lender to include in gross income amounts that would have been included had the lender not loaned the digital asset (i.e., "substitute payments"). The proposals would be effective for taxable years beginning after December 31, 2022.

B. Apply the Mark-to-Market Rules to Digital Asset Dealers and Traders

Sections 475(e) and 475(f) allow commodities dealers and securities traders to mark-to-market their commodities and securities and treat the gains and losses as ordinary gain or loss. The Biden Administration would extend the mark-to-market election to actively traded digital assets, derivatives on actively traded digital assets, and hedges of those digital assets. The proposal clarifies that digital assets would be treated as a third category of assets, distinct from securities and commodities, to be governed by rules similar to those for actively traded commodities. The proposals would be effective for taxable years beginning after December 31, 2022.

C. Require Information Reporting for Digital Asset Transactions

1. 1. *Financial Institutions and Digital Asset Brokers*

The Foreign Account Tax Compliance Act ("FATCA") requires foreign financial institutions to report to the IRS information about accounts held directly or indirectly by U.S. taxpayers. FATCA also requires brokers to report information about their customers to the IRS, including the identity, gross proceeds from sales of securities and certain commodities, and cost basis information for certain securities of customers.

The Biden Administration would expand FATCA's reporting requirements to accounts owned by foreign persons and maintained at a U.S. office, as well as certain non-U.S. source payments. In addition, financial institutions, including U.S. digital asset exchanges, would be required to report information about certain passive entities and their foreign owners, and digital asset brokers would be required to report gross proceeds and other information with respect to their customers.[7] The proposals would be effective for taxable years beginning after December 31, 2022.

1. 2. *Taxpayers with Foreign Digital Asset Accounts*

Section 6038D requires taxpayers with an interest in certain foreign assets with an aggregate fair market value of more than $50,000 during a taxable year to report the name and address of the financial institution where an account is maintained, the account number, and identifying information about assets not held in a financial account.

The Biden Administration proposes to amend section 6038D(b) to require reporting with respect to any account that holds digital assets maintained by a foreign digital asset exchange or other foreign digital asset service provider. The proposals would be effective for taxable years beginning after December 31, 2022.

V. Taxation of Investments in Real Property

A. Restrict Deferral of Gain for Like-Kind Exchanges under Section 1031

The Biden Administration has proposed to limit the gain that can be deferred under a like-kind exchange of real estate under section 1031 to $500,000/year for individual taxpayers (or $1 million/year for married individuals filing jointly). Taxpayers will be required to recognize gain in excess of the $500,000/$1 million threshold in the year the real property is exchanged. The proposal does not apply to real estate investment trusts ("REITs") or C corporations, and therefore it appears that individuals are unrestricted in their ability to benefit from like-kind exchanges through these entities.

If the proposal is enacted, one would expect to see increased use of Up-REITs, "mixing bowls", and long-term net leases. These arrangements all allow tax-deferral while reducing a taxpayer's economic risk in the underlying real estate. An Up-REIT is a structure under which a REIT owns a partnership that holds real property. Investors contribute appreciated property to the partnership in a tax-free exchange for a partnership interest and the ability to exchange the partnership interest for an interest in the REIT. Up-REITs allow deferral, diversification, and (for publicly-traded REITs) liquidity. In a mixing bowl transaction, a taxpayer contributes appreciated real estate to a partnership and, after a specified period of time (typically seven years), the real estate is distributed to another partner and the contributing partner retains an economic interest in the partnership's other assets. In a long-term lease, the taxpayer locks-in a fixed economic return over a long-term period. These transactions would not be affected by the Biden Administration proposal.

B. Treat 100% of Depreciation Recapture on the Sale of Section 1250 Property as Ordinary Income

The Biden Administration has proposed to treat all gain on section 1250 property held for more than a year as ordinary income to the extent of cumulative depreciation deductions taken after December 31, 2022. Depreciation deductions taken on section 1250 property prior to December 31, 2022 would continue to be subject to current rules (and subject to recapture only to the extent the depreciation exceeds the amount that would be allowable under a straight-line method). Any gain on the sale of section 1250 property in excess of depreciation recapture would continue to be treated as section 1231 gain. Any unrecaptured gain on section 1250 property would continue to be taxable to noncorporate taxpayers at a maximum 25% rate.

Under current law, section 1250 requires a certain amount of the gain from the sale or disposition of certain depreciable real property used in a trade or business to be "recaptured", or recharacterized as ordinary income, to the extent of prior depreciation deductions taken on that property.[8] For property held for one year or less, the amount of gain recaptured is all prior depreciation deductions. For property held for more than one year, the amount of gain recaptured is the amount of depreciation that exceeds the amount that would have been allowable under a straight-line method. Accordingly, only gain attributed to deductions equal to the difference between those taken under an accelerated depreciation method or bonus depreciation and those allowable under a straight-line method is recaptured and taxed at ordinary rates. This would be changed under the Biden Administration proposal. For noncorporate taxpayers, gain that is attributable to straight-line depreciation, or "unrecaptured 1250 gain," is taxed at a maximum rate of 25%. This rule would remain under the Biden Administration proposal

In addition, under section 1231, noncorporate taxpayers treat section 1231 losses as ordinary losses and section 1231 gain as long-term capital gain. This rule would remain under the Biden Administration proposal.

The Biden Administration proposal would not apply to noncorporate taxpayers with an adjusted taxable income below $400,000 (or $200,000 for married individuals filing separately). These income amounts would be calculated before applying the proposed 100% depreciation recapture on section 1250 property.

Under the Biden Administration proposal, flow-through entities would be required to compute the character of gains and losses on the sale or disposition of section 1250 property and report to the entity owners the amounts of ordinary income or loss, capital gain or loss, and unrecaptured section 1250 gain under both existing and proposed rules. Owners with income of at least the $400,000/$200,000 threshold amount would report tax items calculated under the proposed rules.

The proposal would be effective for depreciation deductions taken on section 1250 property in taxable years beginning after December 31, 2022, and sales or dispositions of section 1250 property completed in taxable years beginning after December 31, 2022.

VI. Partnership Taxation

A. Tax Carried Interests as 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.

Under the Biden Administration’s proposal, 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. [9] The proposal suggests that income or gain attributable to goodwill or other assets unrelated to the provision of services will not be taxed as ordinary income, and the Administration intends to develop mechanisms with Congress to determine how much of the income or gain from an ISPI should be recharacterized.

The Biden Administration would define 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 “specified assets” (generally limited to investment-type assets).

Under the Administration's proposal, a partnership would 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 Administration's 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 Administration's proposal, 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" would 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 be 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. The proposal'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-S ervice Partners" is significant.

The Administration's proposal 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 would be subject to tax at “rates applicable to ordinary income” on any income or gain received with respect to the interest.

A “disqualified interest” would be 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 the 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 Administration’s 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).

B. Prevent Basis Shifting by Related Partners

Under current law, if a partnership with appreciated non-depreciable assets and depreciable or amortizable assets makes a “section 754 election” and distributes the appreciated non-depreciable assets on a tax-free basis to one partner whose outside tax basis in the distributed asset is less than the partnership’s adjusted basis in the asset, the other partners are entitled to “step-up”, or increase, their basis in the depreciable or amortizable assets. This allows them to claim increased depreciation or amortization deductions or generate losses from assets to be sold. These transactions are known as “basis bumps”.

A section 754 election is an election that allows a partner that purchases an interest in a partnership to adjust its share of the partnership’s “inside” tax basis in its assets to fair market value and permits the partners in a partnership to adjust their inside basis in partnership assets upon the distribution of an asset to another partner. The increase in basis upon the distribution of an appreciated asset is generally equal to the (i) distributee-partner’s gain; or if a distributee-partner takes a lower basis in the distributed asset than that partner’s inside basis before the distribution, (ii) the amount by which the partnership’s basis exceeds the distributee-partner’s basis in the distributed asset immediately before distribution.

Two related partners in a partnership can use this rule to generate increased amortization or depreciation deductions for one of the partners by distributing an appreciated non-depreciable asset to the other. Additionally, these transactions can be used to reduce gain or generate a loss on assets that are anticipated to be sold, while continuing to hold the low basis assets.

The Biden Administration has proposed to prevent related parties in a partnership from using this rule to generate deductions by prohibiting any partner related to the distributee-partner from benefitting from the partnership’s basis step-up until the distributee-partner disposes of the distributed asset in a fully taxable transaction. In addition, the proposal would authorize Treasury to issue regulations to implement this matching rule with respect to related-party partners. The proposal does not define “related” for these purposes.

The proposal has no effect on unrelated partners that use the same strategy to generate increased depreciation or amortization deductions by causing the partnership to distribute appreciated assets to one of the partners.

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

C. Amend the Centralized Partnership Audit Regime

1. 1. *Permit the Carryover of a Reduction in Tax that Exceeds a Partner's Tax Liability*

Section 6225 generally requires a partnership to pay tax attributable to adjustments as the result of an audit in the prior allocation of income, gain, loss or deductions to the partners, unless the partnership has made a "push-out" election under section 6226, in which case, the partners that were partners in the taxable year under audit bear the taxes, interest, and penalties attributable to the adjustment. For partners subject to audit for multiple years or whose adjustments in a single audited year affect their tax liability in subsequent years, section 6226 allows the partners to net the amounts for each year and report either an additional tax or tax reduction in the year in which they take into account their share of adjustments (the "reporting year"). However, if the calculation results in a net decrease, the partners can use the decrease to reduce their reporting year tax liabilities to zero and cannot benefit from a refund or carry forward.

The Biden Administration helpfully proposes to permit partners that receive a favorable adjustment under section 6226 (i.e., partners who paid too much tax) to treat the excess as an overpayment under section 6401 that may be refunded.

The proposal would be effective on the date of enactment.

1. 2. *Incorporate the 3.8% Medicare tax and Self-Employment Taxes in the Centralized Partnership Audit Regime*

As mentioned above, under the general rule of section 6225, partnership adjustments made as a result of an audit are assessed against the partnership. However, section 6225 applies only to income taxes and not to self-employment, or the 3.8% Medicare tax on "net investment income" Self-employment and net investment income taxes are subject to the old audit rules (i.e., before the Bipartisan Budget Act of 2015 (the "BBA") amended the audit rules).

Thus, the IRS conducts one audit proceeding under the BBA rules for income taxes and a separate audit proceeding under the pre-BBA rules for net investment income and self-employment taxes. Taxpayers may have to amend multiple returns as a result.

The Biden Administration would helpfully include net investment income and self-employment taxes in the BBA audit rules that apply to income taxes.

The proposal would be effective after the date of enactment for all open taxable years.

VII. Private Foundation Taxation

Limit Use of Donor Advised Funds to Avoid Private Foundation Payout Requirement

Under section 4942, private nonoperating foundations are generally required to annually distribute 5% of the fair market value of their assets directly for charitable purposes.[10] These distributions are referred to as "qualifying distributions." A 30% excise tax is imposed on the undistributed amounts.

If a private foundation establishes a donor advised fund ("DAF"), its distributions to the DAF are generally treated as qualifying distributions. A DAF is a section 501(c)(3) public charity with respect to which a donor (or the donor's designee) has or reasonably expects to have advisory privileges with respect to the distribution or investments of amounts held in the public charity by reason of the donor's status as a donor. Amounts held by a DAF are not subject to a distribution requirement.

The Biden Administration has proposed that a private foundation's distribution to a DAF is not a qualifying distribution unless (i) the DAF funds are expended as a qualifying distribution by the end of the taxable year following the distribution; and (ii) the private foundation maintains adequate records or other evidence showing that the DAF has made a qualifying distribution within that time frame.[11]

The proposal would be effective after the date of enactment.

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[1] On October 8, 2021, the OECD/G20 member states agreed in principle to two "pillars" to reform international taxation rules. "Pillar One" would address digitalization and allow countries to tax very large multinational companies that do not have a physical presence in the taxing jurisdiction. The GloBE rules of "Pillar Two" contain mechanisms to identify pools of low-taxed income in multinational groups and imposes a minimum effective rate of tax of 15% in each jurisdiction in which the groups operate.

[2] Unless otherwise stated, all references to sections are to the Internal Revenue Code or Treasury regulations.

[3] The Green Book provides the following example:

A group with $1,000x of profits in a foreign jurisdiction with no corporate income tax would have a top-up tax amount of $150x with respect to that jurisdiction. If the top-up tax were not collected under GILTI or an IIR implemented by a foreign jurisdiction, a U.S. corporation or U.S. branch that is a member of the group would be subject to a deduction disallowance of $536x, equal to the top-up tax amount of $150x divided by the U.S. corporate income tax rate of 28 percent. (For simplicity, this example assumes that there are no tangible assets or payroll in the foreign jurisdiction with no corporate income tax, and that there are no other jurisdictions with a UTPR such that all of the top-up tax is allocated to the U.S. corporation or U.S. branch.)

A financial reporting group is any group of business entities that prepares consolidated financial statements and that includes at least one domestic entity or domestic branch and at least one foreign entity or foreign branch. “Consolidated financial statements” means those determined in accordance with U.S. Generally Accepted Accounting Principles (“GAAP”), International Financial Reporting Standards (“IFRS”) or other methods authorized by the IRS under regulations.

[4] The reduction corresponds to the “substance based income exclusion” in the OECD/G20 rules.

During a transition period of nine years, the exclusion would be 7.8% of the book value of tangible assets and 9.8% of payroll, declining annually by 0.2 percentage points for the first four years, by 0.4 percentage points for tangible assets and by 0.8 percentage points for payroll for the last five years.

[5] Taxpayers that loan securities pursuant to agreements that fail to satisfy section 1058 may be taxable initially and when they receive back the loaned securities.

[6] The securities loan agreement must (i) provide for the return to the transferor of securities identical to the securities transferred; (ii) require payments made to the transferor of amounts equal to all interest, dividends and distributions on the security during the term of the loan; (iii) not reduce the risk of loss or opportunity for gain of the transferor of the securities in the securities transferred; and (iv) meet other requirements as the IRS may prescribe by regulation. §1058(b).

[7] A broker would be defined as "any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person".

[8] For this purpose, "sale or disposition" includes sale, exchange, involuntary conversion, transfer by corporation to shareholder, transfer in a sale-leaseback transaction, and transfer upon foreclosure of a security interest. Treasury regulations section 1.1250-1(a)(4).

[9] The House of Representatives' September 2021 version of the Build Back Better Act (the "BBBA") would have extended the holding period to qualify for long-term capital gains for carried interests from three to five years for holders with an adjusted gross income in excess of $400,000 per year. However, the proposal was not included in the October 2021 version of the BBBA (which contained no carried interest proposals). For more information about the BBBA, read our prior blog post here: Senator Manchin Announces That He Will Not Support the Build Back Better Act – Where Things Stand Now | Tax Talks (proskauertaxtalks.com)

[10] Private nonoperating foundations with acquisition indebtedness must annually distribute at least 5% of the excess of the aggregate fair market value of their non-charitable use assets over the acquisition indebtedness with respect to such assets. Certain other adjustments are required under section 4942(f)(2)(C).

Distributions that satisfy the requirements of section 4942 are (i) direct expenditures used to acquire assets; (ii) administrative expenses related to the foundation's exempt purposes; or (iii) grants to public charities and private operating foundations. Certain distributions to supporting organizations do not count for these purposes.

[11] Senators Chuck Grassley (R-IA) and Angus King (I-ME) made a similar but more comprehensive proposal in the Accelerating Charitable Efforts Act.

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