The House Ways and Means Committee Finally Provides Draft Legislative Language for the Tax Changes First Set Forth in President Biden's American Jobs and American Families Plan

September 2021

In April 2021, President Biden announced the "American Families Plan," which included some significant tax law changes. On May 28, 2021, the United State Department of Treasury issued a report entitled "General Explanation of the Administration's Fiscal 2022 Revenue Proposals" (commonly referred to as the "Green Book"), which was one of the first times that additional details on President Biden's tax proposal were published.

On September 13, 2021, and over the days following, the House Ways and Means Committee released their highly anticipated 881 pages of legislative text detailing their proposed tax increases as part of the "Build Back Better Act.". At the end of the week of September 13th, the House Ways and Means Committee had concluded its two-day mark-up of the tax provisions. While the legislative future of these proposed tax law changes is currently far from clear, the following is a comparison of what was proposed in May to what is now being proposed in the draft legislative text.

1. Proposed Tax Law Change Applicable to Long-Term Capital Gains of Non-Corporation Taxpayers

Current Law:

Entities that are taxable as C corporations for U.S. federal income tax purposes are subject to the same tax rate on taxable income regardless of whether the income is ordinary income or capital gain. In contrast, for individuals who recognize income directly or as a result of the flow-through of items of income, gain, loss and deduction from a limited liability company or S corporation, a different tax rate will apply depending upon whether the income is ordinary income or capital gain.

In general, if an individual sells a capital asset that has been held for more than 12 months, the regular marginal rates do not apply and instead, tax is imposed at a rate of up to 20% on the excess of the amount realized on the sale over the seller's tax basis in the asset. If these gains are passive in nature, the net investment income tax of 3.8% may also apply.

May Proposal:

Under the proposed tax law change set forth in the Green Book, gain arising from the sale of a capital asset that has been held for more than 12 months (i.e., a long-term capital gain) would be subject to U.S. federal income tax at ordinary income rates, with the top marginal rate of 37%. This proposed tax rate increase would apply only to

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the extent that the taxpayer's income exceeds $1 million. This threshold amount would be adjusted by the consumer price index that is used to index other tax rate thresholds. Under this proposal, if the sale was also subject to the 3.8% net investment income tax, the tax rate for U.S. federal tax purposes would be 40.8%.

September Ways and Means Draft Legislation:

The new proposal does not incorporate methodology on increasing the long-term capital gain rate to a rate equal to the highest ordinary income tax rate. Instead, the new proposal simply increases the maximum capital gains rate from 20% to 25%. This increase will apply to tax years ending after the date of introduction of the legislation (September 13, 2021). This means that the preexisting statutory rate of 20% will continue to apply to gains and losses for the period up to September 12, 2021. In addition, a proposed transition rule provides that if a binding written contract is entered into prior to September 13, 2021, any gains recognized on or after September 13, 2021, that arise from that binding contract, are treated as occurring prior to the date of introduction and still subject to the 20% rate. However, other capital gains recognized on or after September 13, 2021, would be subject to the 25% rate.

2. Proposed Tax Law Change Applicable to Marginal Income Tax Rate

Current Law:

The 2017 Tax Cuts and Jobs Act (the "TCJA") changed the marginal tax brackets that applied to individuals for purposes of determining the U.S. federal income tax rate applicable to ordinary income. Under the TCJA, the top marginal tax rate for such income was lowered from 39.6% to 37% for income over $628,300 for married individuals filing a joint return (for 2021). The elimination of the 39.6% tax bracket under the TCJA was set to expire on January 1, 2026.

May Proposal:

The proposal released in May described a change to the marginal tax rates to reinstate the 39.6% marginal tax rate and to have it apply to taxable income over $509,300 for married individuals filing a joint return for 2022. For future tax years, the $509,300 threshold would be adjusted by the consumer price index that is used to index other tax rate thresholds. The reinstatement of the 39.6% tax bracket and the lowering of the taxable income threshold for this top marginal rate would apply to taxable years beginning after December 31, 2021.

September Ways and Means Draft Legislation:

The new proposal includes a similar increase to the top marginal rate. However, in the proposed legislative language, this higher 39.6% rate would apply to taxable income over $450,000 for married individuals filing a joint return. This proposed change, if enacted, would apply to tax years beginning after December 31, 2021.

3. Proposed Tax Law Change Increase to the Tax Rate Applicable to C Corporations

Current Law:

The TCJA eliminated the concept of marginal tax rates for entities that are treated as C corporations for U.S. federal income tax purposes. Under the TCJA, C corporations were subject to U.S. federal income tax at a flat rate of 21%.

May Proposal:

Proposal release in May described a change that would continue the elimination of marginal tax rates but increase the rate of tax to a flat 28%.

September Ways and Means Draft Legislation:

The new proposal adopts a different approach than the proposal described in May. Under the draft legislative language released in September, the flat corporate income tax rate would be replaced with a graduated rate structure similar to the one that applied prior to the TCJA. Under the new proposal, there would be an 18% tax rate that would apply up to the first $400,000 of net income, then a 21% rate that would apply on the net income that exceeds $400,000 but less than $5 million, and a 26.5% rate that would apply to net income in excess of $5 million.

This proposed change, if enacted, would apply to tax years beginning after December 31, 2021.

4. Proposed Tax Law Change to the Tax Treatment of Carried Interests

Current Law:

Over the past several years, the tax treatment of "carried interests" has been the subject of much discussion. In general terms, a "carried interest" is structured as an interest in a limited liability company or limited partnership and is granted to service providers. In 2017, the TCJA amended Code Section 1061 to impose new tax rules on carried interest that imposed ordinary income treatment if the carried interest was held less than three years. Under the TCJA, this three-year holding period did not apply to certain real estate partnerships.

May Proposal:

The proposal released in May described another wholesale change to the tax rules applicable to "carried interest." Under the proposal released in May, any amount allocated to an investment services partnership interest (an "ISPI") would be subject to tax at ordinary rates regardless of the character of the gain at the partnership level.

Under this proposal, the gain arising from the disposition of an ISPI would likewise be treated as ordinary income, regardless of how long the interest was held. The income allocated in respect to an ISPI would also be subject to self-employment tax ("SECA"), notwithstanding whether the interest was a limited partnership interest that is otherwise exempt from SECA or a non-manager interest in an LLC. This ordinary income treatment would apply only if the individual's income from all sources exceeded $400,000.

September Ways and Means Draft Legislation:

The new proposal adopts a different approach than the proposal described in May. Under the proposed legislative language released in September, the three-year holding period described in the new rules set forth in the TCJA is increased to five years. However, the proposed legislative language has an exception to this increased holding period for taxpayers with an adjusted gross income of less than $400,000 and for real property trades or businesses – where the three-year holding period will continue to apply.

The provisions of the proposed legislative language also states that if there is a transfer of an "applicable partnership interest" to an unrelated party, taxable gain will be recognized on the transfer notwithstanding any other provisions that would otherwise result in non-recognition. Details of this new proposed gain recognition rule are not set forth in the draft legislative language and instead, the draft language provides that subsequently issued Treasury Regulations will provide such details.

The draft legislative language would also extend this carried interest to all assets eligible for long-term capital gain treatment and not just capital assets. (As drafted, the carried interest rules set forth in the TCJA did not apply to Code Section 1231 gains, which are gains arising from the sale of property used in a trade or business.)

This proposed change, if enacted, would apply to tax years beginning after December 31, 2021.

5. Proposed Tax Law Change to the Deferral of Gain on the Sale of Real Estate under the Like Kind Exchange Rules

Current Law:

Code Section 1031 allows a taxpayer to avoid the current recognition of taxable gain on the sale of property by engaging in a like kind exchange. In 2017, the TCJA amended Code Section 1031 to limit application of the like kind exchange rules to real property.

May Proposal:

The proposal released in May described a change to the rules of Code Section 1031 that would further restrict the application of Code Section 1031 by limiting the amount of gain that could be deferred in a like kind exchange to $500,000 ($1,000,000 for married individuals filing a joint return).

September Ways and Means Draft Legislation:

This proposed change to Code Section 1031 was not included in the draft legislative language released in September.

6. Proposed Tax Law Change Applicable to the New Requirement to Recognize Long-Term Capital Gains for Assets Held at Death or Transferred During Lifetime

Current Law:

In general, the current tax laws provide that the recipient's basis of property acquired at death is the fair market value of those assets as of the decedent's date of death. The recipient's basis of property acquired by gift is the same as the donor's basis as of the date of such gift. There is no realization event when property is acquired at death or via gift, unless and until that property is subsequently sold (and any gain would be determined based on the recipient's adjusted basis).

May Proposal:

The proposal released in May described a change to current law that would have required a realization of capital gains to the extent such gains are in excess of a $1 million exclusion per person, upon the transfer of appreciated assets at death or by a gift, including transfers to and distributions from irrevocable trusts and partnerships. The proposal would provide various exclusions and exceptions for certain family-owned and operated businesses.

September Ways and Means Draft Legislation:

This proposed change was not included in the draft legislative language released in September.

7. Proposed Tax Law Change to Expand Income Subject to the Net Investment Income Tax or SECA Tax

Current Law:

Under current tax law, individuals filing joint returns that have taxable income in excess of $250,000 are subject to the 3.8% net investment income tax. In general, the net investment income tax applies only to the following categories of income and gain: (i) interest, dividends, rents, annuities and royalties, (ii) income derived from a trade or business in which the individual does not materially participate, and (iii) net gain from the disposition of property (other than property held for use in a business in which the individual materially participates).

The net investment income tax does not apply to self-employment earnings. However, self-employment earnings are subject to SECA. Under Code Section

1402, limited partners are statutorily exempt from SECA, as are shareholders of an S corporation on the flow-through of income from the S corporation. In general, the statutory exclusion of limited partners from SECA has been widely interpreted to also exclude members of limited liability companies from SECA.

May Proposal:

The proposal released in May described new tax rules designed to ensure that all trade or business income is subject to an additional 3.8% tax either through the net investment income tax or SECA. Specifically, under the proposal released in May, if an individual had adjusted gross income of more than $400,000, the net investment income tax would apply to all income and gain from a business that was not otherwise subject to SECA (or regular employment taxes).

The proposal released in May also includes a change to the scope of SECA. Under this proposal, all individuals who provide services and materially participate in a partnership or a limited liability company would be subject to SECA on their distributive share of income that flows through from the entity. In addition, under this proposed tax law change, a shareholder of an S corporation that materially participated in the business of the S corporation would be subject to SECA on their distributive share of income that flows through from the entity.

The exemptions from SECA for rents, dividends, capital gains, and certain other income would continue to apply. Nonetheless, both of these proposed tax law changes to the net investment income tax and SECA would have the effect of a 3.8% tax rate increase on all income from a business regardless of whether it was conducted through a sole proprietorship, a limited liability company, a partnership, or an S corporation.

September Ways and Means Draft Legislation:

The new proposal adopts a similar approach than the proposal described in May. In addition, the draft legislative language expands the scope of the net investment income tax to include net investment income derived in the ordinary course of a trade or business. This proposed change, if enacted, would apply to tax years beginning after December 31, 2021.

8. Proposed Tax Law Change to the Extend the Excess Business Loss Deduction Limitations

Current Law:

The TCJA added Code Section 461(l) to impose a limitation on the amount of loss from a passthrough business entity that can be used by a taxpayer to offset other income. As currently in force, this limitation applies to non-corporate taxpayers for tax years beginning after December 31, 2020, through 2027.

This limitation applies to "excess business losses" which are defined as the excess of losses from a business activity over the sum of (x) the gains from the business activities and (y) $524,000 for married individuals filing a joint return. This threshold amount is indexed for inflation. The determination of whether there is an "excess business loss" is determined at the individual level rather than on an entity-by-entity basis. As a result, all losses and gains attributable to a business are aggregated for purposes of applying the loss limitation.

May Proposal:

The proposal released in May provided that this limitation would not expire after 2027 and would be permanent.

September Ways and Means Draft Legislation:

The new proposal adopts a similar approach to the proposal described in May. The draft legislative language also provides that any disallowed losses are carried forward and taken into account in the calculation of excess business losses in the following year. The draft legislative language also would permanently repeal the limitation on the deduction of excess farm losses.

This proposed change, if enacted, would apply to tax years beginning after December 31, 2021.

9. Proposed Tax Law Change to Require Financial Institutions to Provide Comprehensive Financial Account Information to the IRS Through 1099 Reporting

The IRS has estimated that the tax gap for business income is $166 billion per year. The IRS believes the primary cause of this tax gap is a lack of comprehensive information reporting and the resulting difficulty identifying noncompliance outside of an audit. In order to decrease the business income tax gap, it is proposed that the IRS will require comprehensive reporting on the inflows and outflows of financial accounts.

Pursuant to the proposal, financial institutions would report data on financial accounts on informational returns, which would report gross inflows and outflows from the accounts. Further, the information return would breakdown the amount of physical cash, any transactions with foreign accounts, and transfers to and from related party accounts. This regime would apply to all business and personal accounts held with financial institutions, including bank, loan, and investment accounts. It is further proposed that payment settlement entities would continue to report gross receipts on Form 1099-K, but would also report gross purchases, physical cash, payments to foreign accounts, and transfer inflows and outflows on its payee accounts. Similar reporting would also apply to cryptocurrency.

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

10. Other Significant Tax Law Changes Included in the Draft Legislation Released in September.

A. SURCHARGE ON HIGH-INCOME INDIVIDUALS, TRUSTS, AND ESTATES

In addition to the other individual tax rate increases discussed above, a 3% surcharge on a taxpayer's modified adjusted gross income in excess of $5,000,000 for individuals, trusts, and estates. This surcharge would apply to tax years beginning after December 31, 2021.

B. TERMINATION OF TEMPORARY INCREASE IN UNIFIED CREDIT

The new proposal terminates the temporary increase in the unified credit against estate and gift taxes, reverting the credit to its 2010 base of $5,000,000 per individual, indexed for inflation. This change would go into effect for gifts made and decedents dying after December 31, 2021.

C. INCREASE IN LIMITATION UNDER CODE SECTION 2032A – SPECIAL USE VALUATION

Under the proposal, the rules under Code Section 2032A would be amended to increase the special valuation reduction available for certain qualified real property used in a family farm or family business. This reduction allows decedents who own real property used in a farm or business to value the property for estate tax purposes based on its actual use rather than fair market value. The allowable reduction would be increased from $750,000 to $11,700,000. This increase would go into effect after December 31, 2021.

D. CHANGES TO CERTAIN TAX RULES APPLICABLE TO GRANTOR TRUSTS

The new proposal adds Code Section 2901, which causes assets owned by grantor trusts to be included in a decedent's taxable estate when the decedent is the deemed owner of the trust. Prior to this provision, taxpayers were able to use grantor trusts to remove assets from their taxable estates. The new proposal also adds Code Section 1062, which treats sales between grantor trusts and their deemed owner as equivalent to sales between the owner and a third party. These changes will apply only to future trusts and future transfers after the date of the enactment of the proposed legislation.

E. NEW VALUATION RULES FOR CERTAIN TRANSFERS OF NONBUSINESS ASSETS

The new proposal amends Code Section 2031 by clarifying that when a taxpayer transfers nonbusiness assets, those assets will not be afforded a valuation discount for transfer tax purposes. Nonbusiness assets are passive assets held for the production of income and not used in the active conduct of a trade or business. Exceptions are provided for assets used in hedging transactions or as working capital of a business. A look-through rule provides that when a passive asset consists of a 10% interest in some other entity, the rule is applied by treating the holder as holding its ratable share of the assets of that other entity directly. This change would apply to transfers after the date of the enactment of the proposed legislation.

F. LIMITATIONS ON THE DEDUCTION OF QUALIFIED BUSINESS INCOME.

Section 199A, adopted by the TCJA, allows non-corporate taxpayers a 20% deduction for certain "qualified business income," provided certain requirements are met. The deduction also applies to REIT dividends and certain income of publicly traded partnerships. The proposal would limit the annual deduction for qualified business income to $500,000 for taxpayers filing jointly (or a surviving spouse), $250,000 for a married taxpayer filing a separate return, $10,000 for an estate or trust, and $400,000 for other taxpayers.

G. MODIFICATION TO THE TREATMENT OF CERTAIN LOSSES

The proposal provides that a Code Section 165 loss relating to worthless security is recognized on the date worthlessness is established (rather than the last day of the year during which worthlessness is established). It also expands the Code Section 165 definition of securities to include securities issued by partnerships. The proposal further provides that a loss from a worthless partnership interest will be treated as a capital loss (subject to the hot asset rules of Code Section 751).

The draft legislative language also provides for the deferral of losses in the case of a taxable liquidation of a corporate subsidiary by not allowing a loss with respect to such taxable liquidation until the property received in the liquidation is sold to a third party.

H. CONSERVATION EASEMENT

The draft legislative language provides that certain charitable contributions of passthrough easements made by partnerships and other flow-through entities are disallowed. The contribution will not be treated as a charitable deduction if the amount of the contribution exceeds two and one-half times the sum of each partner's relevant basis in the partnership with respect to which the qualified conservation contribution is made. The rule does not apply if a three-year holding period is satisfied, determined by the latter of when the last portion of the real property was acquired or when the last partner (direct or indirect) acquired an interest in the partnership. Any underpayment penalty relating to a disallowed contribution is subject to a 40% accuracy-related penalty.

I. CHANGES TO THE SPECIAL GAIN RULES THAT APPLY TO CODE SECTION 1202 STOCK

The draft legislative language provides that for taxpayers with adjusted gross incomes of $400,000 or more for sales and exchanges on or after September 13, 2021 (subject to the binding contract exception), the Code Section 1202 exclusion would only be 50% even if otherwise subject to the 75% or 100% exclusion percentages. Presumably, any gain not excluded by 1202 will be taxed at 28% rather than the lower long-term capital gain rates.

J. TEMPORARY RULES THAT ALLOW CERTAIN S CORPORATIONS TO CONVERT TO PARTNERSHIP TREATMENT TAX-FREE.

The draft legislative language provides certain S corporations can reorganize to be treated as entities that are taxable as partnerships in a tax-free manner. To take advantage of this tax-free treatment: (i) The entity must have been taxed as an S corporation on May 13, 1996; and (ii) the S corporation must completely liquidate and transfer substantially all of its assets and liabilities to a domestic partnership during the two-year period beginning on December 31, 2021.

K. CONTRIBUTION LIMITATIONS FOR LARGE RETIREMENT ACCOUNTS

Under current law, taxpayers are allowed to make IRA contributions regardless of the account's balance. However, the draft legislation prohibits additional contributions to a Roth or traditional IRA for a tax year if the total value of the account exceeds $10,000,000 at the end of the prior tax year. This limit on contributions only applies to single taxpayers with taxable income over $400,000 or married taxpayers filing jointly with income in excess of $450,000.

L. INCREASE IN MINIMUM REQUIRED DISTRIBUTIONS FOR LARGE RETIREMENT ACCOUNTS

Under the proposed legislation, once an individual's Roth IRA, traditional IRA, or defined contribution plans exceed $10,000,000 at the end of the tax year, a minimum distribution of 50% is required the following year. This rule only applies to single taxpayers with incomes in excess of $400,000 and married couples filing jointly with incomes greater than $450,000.

In addition, to the extent that the combined balances of IRA accounts and defined contribution plans exceed $20 million, the excess is required to be distributed up to the lesser of (1) the amount needed to bring the total balance in all accounts down to $20,000,000 or (2) the aggregate balance in the Roth IRAs and designated Roth accounts in defined contribution plans. Once the individual distributes the amount of any excess required under this 100% distribution rule, the individual is allowed to determine the accounts from which to distribute to satisfy the 50% distribution rule above.

This provision is effective for tax years beginning after December 31, 2021.

11. Proposed Changes to Taxation of International Income

A. PROPOSED CHANGES TO GLOBAL INTANGIBLE LOW-TAXED INCOME ("GILTI")

Background

The TCJA enacted the GILTI rules to provide for immediate taxation of the earnings of controlled foreign corporations ("CFC's"). A U.S. shareholder's GILTI inclusion is determined by combining its pro rata share of the tested income and tested loss of all its CFCs. Tested income is the excess of certain gross income of the CFC over the deductions of the CFC that are properly allocable to the CFC's gross tested income. However, this inclusion is reduced by a deemed 10% return on depreciable tangible property of the CFC (referred to as qualified business asset income, or "QBAI").

In addition, a corporate U.S. shareholder is generally allowed a 50% deduction against its GILTI inclusion. Further, for corporate U.S. shareholders, 80% of foreign corporate income taxes attributable to GILTI may be allowed as a foreign tax credit. Finally, Treasury Regulations provide that if the foreign effective tax rate on the gross income of a CFC exceeds 90% of the U.S. corporate income tax rate, the U.S. shareholder of the CFC is generally permitted to exclude that gross income (and the associated deductions and foreign income taxes) from its GILTI inclusion.

Proposal to Reduce GILTI Corporate Deduction

The recently-released new proposal changes the percentage deduction for domestic corporate shareholders with respect to GILTI to 37.5% (from 50%). This is an acceleration of the change that would otherwise have occurred for taxable years beginning after December 31, 2025, to taxable years beginning after December 31, 2021. However, it should be noted that the new proposal is an improvement on the administration's May proposal, which would have reduced the GILTI corporate deduction to 25%.

Proposal to Reduce QBAI Deduction

As noted above, under current law, a CFC's tested income inclusion is reduced by a deemed 10% return on QBAI. The new proposal generally reduces the deemed rate of return on the aggregate of a U.S. shareholder's pro rata share of

QBAI from 10% to 5%, except for United States possessions, which retain the 10% deemed rate of return on QBAI located in such possession.

The administration's May proposal would have eliminated the QBAI deduction so that the U.S. shareholder's entire CFC tested income would have been subject to U.S. tax. Accordingly, the new proposal is an improvement over the May proposal in this regard.

Proposal to Revise GILTI Rules to Apply on Country-by-Country Basis

As noted, under present law, a U.S. shareholder of a CFC must include in gross income its GILTI. GILTI is the excess of the shareholder's net CFC tested income over the shareholder's net deemed tangible income return. The shareholder's net deemed tangible income return equals the excess of 10% of the aggregate of its pro rata share of the QBAI of each CFC over certain interest expense. Accordingly, determining tested income, tested loss, and the deemed tangible income return is the first step in calculating a U.S. shareholder's tested income.

Net CFC tested income means the excess of the aggregate of the shareholder's pro rata share of the tested income of each CFC over the aggregate of its pro rata share of the tested loss of each CFC. Similarly, QBAI (and the deemed tangible income return) is calculated based on the average of the aggregate of the tax bases of a U.S. shareholder's CFC's in specified tangible property. Hence, GILTI is calculated on a worldwide basis at the U.S. shareholder level.

The new proposal would apply the GILTI rules on a country-by-country basis, incorporating a CFC taxable unit concept to determine each relevant country with respect to which a CFC is subject to tax or has a CFC has a taxable presence. Thus, the proposal determines tested income, tested loss and QBAI and certain other items on a country-by-country basis. A U.S. shareholder's GILTI then equals the sum of the amounts of GILTI determined separately with respect to each country with respect to which any CFC taxable unit of such shareholder is a tax resident. This eliminates a taxpayer's ability to use tested losses, and QBAI deemed return from one country to offset tested income from another country.

The proposal also provides that, if, after determining the net CFC tested income of a U.S. shareholder in a particular country for any taxable year, such U.S. shareholder has a net CFC tested loss, such net CFC tested loss of the U.S. shareholder carries over too and is treated as a tested loss in, the next succeeding taxable year with respect to such country.

B. PROPOSED CHANGES TO FOREIGN TAX CREDIT RULES

Background

Under current law, U.S. persons are generally allowed a foreign tax credit for foreign income taxes they pay directly. In addition, a domestic corporation is allowed a deemed paid credit for foreign income taxes paid or accrued by a CFC with respect to subpart F and GILTI included in its income (i.e., the U.S. shareholder may be treated as if it paid all or a portion of the CFC's foreign corporate taxes). For subpart F, this portion is generally the full amount of the CFC's foreign income taxes attributable to the subpart F income. However, for GILTI, the domestic corporation is allowed a credit for 80% of the CFC's foreign taxes attributable to the tested income inclusion.

In addition, the foreign tax credit rules implement a "basketing" system. The foreign tax credit limitation is applied separately to GILTI income, foreign branch income, passive category income, and general category income. These rules are intended to prevent cross-crediting of foreign taxes imposed on one type of basketed income against income of another basket.

Proposal to Adopt of Country-by-Country Limitation Rules

The new proposal applies the foreign tax credit limitation rules on a country-by-country basis, thereby preventing taxpayers from using excess foreign taxes paid to high-tax countries to reduce U.S. tax liability on income earned in low-tax countries. Like the GILTI country-by-country limitations, this proposal applies on a taxable unit basis. Since the basketing system is generally retained (other than with respect to foreign branch income), this proposal apparently would require the existing basketing system to be maintained on a country-by-country basis, interposing yet more complexity into the foreign tax credit system.

Proposal to Repeal Foreign Branch Income Basket

The new proposal would repeal the foreign branch income basket, thereby reducing the number of foreign tax credit limitation categories from four to three.

Proposal to Increase Portion of GILTI Taxes Deemed Paid

The new proposal increases the portion of foreign deemed paid taxes attributable to a GILTI inclusion from the present-law 80% to 95%. Further, in a change to current law, tested foreign income taxes deemed paid would include foreign income taxes attributable to a tested loss. Taxpayers should welcome these changes.

Modification of Carryback and Carryforward Periods

Current law permits a 1-year carryback and 10-year carryforward for excess non-GILTI foreign tax credits. Excess GILTI foreign tax credits can neither be carried back nor carried forward under current law. The new proposal would repeal the carryback of excess foreign taxes and limit the carry forward of such excess foreign taxes to any of the first five succeeding taxable years. The proposal also extends application of the foreign tax credit carryforward rules to excess GILTI tax credits.

C. ELIMINATE DIVIDENDS RECEIVED DEDUCTION FOR CORPORATE SHAREHOLDERS OF NON-CFC'S

Background

Under current law, if a domestic corporate shareholder receives a dividend from a specified 10% owned foreign corporation, a deduction is allowed under section 245A equal to the foreign-source portion of the dividend. In general, a specified 10% owned foreign corporation is any foreign corporation with respect to which any domestic corporation is a U.S. shareholder (a U.S. person who owns at least 10% of the shares of the foreign corporation as determined with the application of attribution principles). These rules apply regardless of whether the foreign corporation is a CFC. Thus, if a domestic corporate shareholder receives a foreign source dividend from a non-controlled foreign corporation, the dividend is not subject to tax upon distribution.

Proposal to Eliminate Deduction for Non-CFC's

The new proposal limits the deduction under section 245A to dividends received from a CFC. However, U.S. shareholders of a non-CFC foreign corporation could elect to treat the foreign corporation as a CFC (which would then subject the U.S. shareholders to the subpart F and GILTI rules) and presumably allow them to claim an indirect foreign tax credit for U.S. tax imposed on such income (subject to the various limitations under the foreign tax credit rules). However, the election is binding on the current U.S. shareholders and all future U.S. shareholders of the foreign corporation and is revocable only with IRS consent.

D. MODIFICATION OF FOREIGN-DERIVED INTANGIBLE INCOME ("FDII") RULES

Background

The TCJA enacted the FDII provisions as an incentive to encourage exports of property and services. Very generally, FDII is the excess of a taxpayer's income from U.S. sources derived in connection with property or services sold by the taxpayer to a foreign person for a foreign use over 10% of QBAI used to produce such property. Domestic taxpayers are allowed a deduction against FDII of 37.5% until December 31, 2025, after which the deduction is to be reduced to 21.875%. However, the proposal released in May, repealed FDII in its entirety, reasoning that it was not an effective way to encourage research and development (R&D) in the United States. Instead, the May proposal suggested that the resulting revenue would be used to incentivize R&D in the United States though no details were provided.

Proposal to Accelerate Reduction of Deduction Percentage

The new proposal retains the FDII rules but reduces the percentage deduction for tax years beginning after December 31, 2021, to 37.5%. In other words, the proposal accelerates the change in deduction percentages that would otherwise not have occurred until taxable years beginning after December 31, 2025.

E. MODIFICATIONS TO BASE EROSION AND ANTI-ABUSE TAX ("BEAT") RULES

Background

The BEAT was also enacted by the TCJA. Under the BEAT rules, a minimum tax is imposed on certain large corporate taxpayers (with average gross receipts in excess of $500 million) that make deductible payments to foreign-related parties above a specified threshold. However, the BEAT tax generally does not apply to taxpayers for which reductions to taxable income arising from payments to foreign-related parties are less than 3% of total deductions. For taxpayers to whom the BEAT rules apply, a taxpayer's BEAT liability is computed by reference to the taxpayer's modified taxable income, comparing the resulting amount to the taxpayer's regular tax liability. The taxpayer's BEAT liability generally equals the difference, if any, between 10% of the taxpayer's modified taxable income and the taxpayer's regular tax liability.

The proposal released in May repealed the BEAT and replaced it with a new rule referred to as SHIELD, which would have disallowed deductions of a domestic corporation or branch, in whole or in part, by reference to all gross payments that are made (or deemed made) to low-taxed members of the taxpayer's affiliated group.

Proposal to Retain and Modify BEAT Rules

The new proposal retains and modifies the BEAT rules instead of adopting the SHIELD rules introduced by the May proposal. As an initial matter, the new proposal changed the threshold for determining which companies are applicable to taxpayers. For taxable years beginning after December 31, 2023, the BEAT tax is no longer limited to taxpayers with a 3% or greater base erosion percentage. Accordingly, with limited exceptions, all corporations that meet the gross receipts threshold are subject to the BEAT.

In addition, the rate of BEAT tax is changed. Under the TCJA, the BEAT tax was calculated as 10% of base erosion minimum tax amount. However, for tax years beginning after December 31, 2025, the rate was increased to 12.5%. The new proposal would make the 12.5% rate effective for taxable years beginning after December 31, 2023. Further, the BEAT tax rate would increase to 15% for tax years beginning after December 31, 2025.

Further, the new proposal proposed certain changes to the applicable calculations required under the BEAT to target base-eroding activities and undertaxed payments, including modified taxable income, base erosion benefits, and payments. Of particular note, the existing law generally excludes cost of goods sold from the scope of base erosion payments. While the new proposal generally retains this exception, it adds certain limitations, including on related party purchases of inventory. In that regard, costs incurred in acquiring inventory from a related party are treated as base erosion payments to the extent that such costs exceed the sum of the direct costs and indirect costs of the foreign-related party.

Finally, the new proposal would add exceptions for base erosion payments subject to federal income tax or foreign tax in excess of the BEAT tax rate. Thus, payments that are subject to Federal income tax at either the payor or the payee level are outside the scope of base erosion payments, without regard to whether the income related to such payments was eligible for a reduced rate of tax. In addition, payments that are subject to foreign income tax at an effective tax rate at least equal to the applicable BEAT tax percentage in a taxable year would fall outside the scope of BEAT limitations.