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Summary of Build Back Better Act House Bill and Senate Proposals

Here's a summary of the tax aspects of the House Bill and Senate Proposals for the Build Back Better Act that are of most interest to U.S. corporate taxpayers, financial institutions, hedge funds, private equity funds, and their investors.

I. Introduction

The House Bill and Senate Proposals for the Build Back Better Act (the BBBA) would, among other things:

- establish a minimum corporate tax based on book income;
- raise income tax rates for high-income individuals;
- expand the deductibility of state and local taxes against federal taxes;
- impose new limitations on interest deductions for large corporations; and
- increase U.S. taxes on foreign earnings of multinationals.

Unlike the House Ways and Means Committee's earlier proposal (which we discussed here) the version of the BBBA that the Senate Finance Committee drafted (the Senate Proposals), like the version that the House passed (discussed here) (the House Bill), would not increase the “headline” corporate or individual income tax rates or curtail the tax benefits of carried interests.

The Senate Proposals are largely similar to the version that the House passed in most respects, (together, the BBBA). Notable differences in the Senate Proposals include allowing a partial deduction for dividends received from foreign corporations that are not CFCs and an expansion of the anti-inversion rules. The differences between the Senate Proposals and the House Bill are discussed [here].

The debate over the cap on the deductibility of state and local taxes (SALT) has emerged as a key point of disagreement among Senate Democrats. While the House Bill increased the SALT cap from $10,000 to $80,000, the Senate Proposals contain only a placeholder for insertion of a compromise SALT provision, should one be reached.

Amidst reports that lawmakers aim to vote on the legislation before the year's end, the House Bill and Senate Proposals will remain subject to change and amendment.

This Summary of the House Bill and Senate Proposals concentrates on the tax proposals that are of most interest to U.S. corporate taxpayers, financial institutions, hedge funds, private equity funds, and their investors. Part II discusses corporate tax measures. Part III discusses individual and partnership tax measures.

II. Corporate Tax Measures

- **Impose an alternative minimum corporate tax based on book income.** The BBBA would impose a 15% minimum tax on the worldwide book income of domestic corporations that have worldwide book income in excess of $1 billion (or $100 million for certain foreign-parented corporations) for tax years beginning after 2022. This proposal is similar to a proposal in Biden's Greenbook, which we discussed here.

- **Impose an excise tax on stock buybacks.** Publicly traded corporations would be liable for a 1% tax on the FMV of stock buybacks. The proposal would exempt certain repurchases in connection with tax-free reorganizations, repurchases treated as dividends, and repurchases for retirement or similar plans. The tax would apply to stock buybacks made after 2021.

- **Limit deductions for disproportionate U.S. leverage.** Under section 163(j) (enacted by the TCJA), U.S. corporations generally are allowed a deduction for business interest expense only to the extent that it exceeds their business interest income plus 30% of EBITDA (or EBIT, beginning after 2021). The House Bill would further limit interest deductions of U.S. members of multinational groups that prepare consolidated financial statements if their net interest expense for financial reporting purposes exceeds 110% of their proportionate share (determined based on their share of the group's EBITDA) of the net interest expense reported on those financial statements. The Senate Proposals contain similar provisions but would also allow corporations to elect to use aggregate adjusted bases of the assets rather than EBITDA for calculating their share of reported net interest expense.

  The proposal would be effective for tax years beginning after 2022, and would apply only to U.S. corporations whose average annual net interest expense (determined on a three-year rolling basis and taking into account all U.S. corporations in the group) exceeds $12 million. Interest expense disallowed under either section 163(j) or new section 163(n) could be carried forward.

- **Increase the GILTI tax.** Under the TCJA, U.S. corporations generally are taxed annually at a 10.5% rate (increasing to 13.125% in 2026) on the excess of certain "global intangible low-tax income" earned by their controlled foreign corporations (CFCs) over a 10% imputed return on depreciable tangible property held by the CFCs. For tax years beginning after 2022, the BBBA would increase the GILTI tax rate to 15.015% and replace the 10% imputed return with a 5% imputed return. The BBBA also would modify the GILTI regime to operate on a country-by-country basis, allow carryforwards of country-specific GILTI deductions, and increase the foreign tax credit for GILTI income.

- **Reduce the FDII deduction.** The TCJA grants U.S. corporations a 37.5% deduction (decreasing to 21.875% in 2026) for certain “intangible income” that they derive from exports (so-called "foreign derived intangible income"). The BBBA would permanently reduce the deduction to 24.8% for tax years beginning after 2022.

- **Modify the BEAT.** Under the TCJA’s “base erosion and anti-abuse tax,” corporations with average gross receipts exceeding $500 million are subject to a minimum tax add-on generally equal to 10% (increasing to 12.5% in 2026) multiplied by the excess by which their “BEAT liability” (calculated by adding back certain deductible payments made to foreign affiliates) exceeds their regular tax liability. A *de minimis* exception generally allows up to 3% of a corporation’s total deductions (or 2% for groups that include banks and securities dealers) to be made to foreign affiliates before the BEAT applies.

  The BBBA would increase the BEAT to 12.5% beginning in 2023, 15% beginning in 2024, and 18% beginning in 2025, and would eliminate the *de minimis* exception beginning after 2024.

- **Curtail tax-free spinoff monetization.** Under current law, subject to certain limitations, a subsidiary (Spinco) can issue debt securities to its parent corporation that the parent corporation can then distribute tax-free to creditors in redemption of its own outstanding debt in connection with a spinoff of the Spinco. Beginning after the date of its enactment (subject to a transition rule for certain pending transactions), the BBBA generally would require the parent corporation to recognize gain to the extent that the amount of Spinco debt that it transfers to its creditors exceeds (1) the aggregate basis in any assets it transfers to the Spinco less (2) (a) any liabilities the Spinco assumes from it and (b) any payments the Spinco makes to it.

- **Defer worthless stock deductions on subsidiary liquidations.** Beginning after the date of enactment, the BBBA would defer a corporate parent’s worthless stock loss on the liquidation of an insolvent subsidiary (a so-called *Granite Trust* transaction) until the parent disposes of substantially all of the subsidiary’s property to unrelated persons.

- **Repeal CFC downward attribution.** Taxpayers may be subject to adverse tax consequences, including “phantom income,” if they are 10% United States shareholders in a CFC. Very generally, a CFC is any foreign corporation more than 50% of whose voting power or value is directly, indirectly, or constructively owned by 10% United States shareholders.

  The TCJA expanded constructive ownership to include downward attribution, so that a subsidiary is deemed to own all of the stock owned by any 50% shareholder. As a result of this expansion, if (for example) a foreign parent owns a U.S. subsidiary and a foreign subsidiary, the U.S. subsidiary is deemed to own all of the stock of the foreign subsidiary, so that the foreign subsidiary is treated as a CFC, which could have adverse tax consequences for any 10% United States shareholders of the parent (even if 10% United States shareholders collectively own no more than 50% of the parent).

  Effective after the date of enactment, the BBBA would repeal downward

attribution, and would instead more narrowly target the transactions that downward attribution was intended to address, namely decontrol strategies effected in connection with corporate inversions.

- **Limit the participation exemption.** Section 245A (enacted by the TCJA) exempts U.S. corporations from tax on dividends paid by certain 10%-owned foreign corporations, even when the foreign corporations are not CFCs so that their earnings are not subject to current U.S. taxation under the subpart F and GILTI regimes. The Senate Proposals would limit the 100% exemption to dividends paid by CFCs and allow a 50% credit for 10%-owned foreign corporations that are not CFCs. By contrast, the House Bill permits a deduction only for such dividends paid by CFCs. U.S. corporations would be allowed to elect to treat certain foreign corporations as CFCs. The proposal would apply retroactively to tax years beginning after the date of enactment.

- **Modify the portfolio interest exemption.** The broad "portfolio interest exemption" eliminates withholding tax on U.S.-source interest paid to foreigners. The exemption does not apply to 10% shareholders, who instead are subject to withholding on interest at a 30% rate unless an income tax treaty provides otherwise. Under current law, a 10% shareholder is a holder of at least 10% of the debtor corporation's *voting power*. The BBBA would amend the definition to include a holder of at least 10% of the *value* of the debtor corporation's stock. Thus, large foreign shareholders of a domestic corporation would not be able to avoid withholding tax by holding "low vote" stock. The amendment would apply to debt issued after the BBBA's enactment.

- **Expand the inversion rules.** Under the current anti-inversion regime, when a foreign corporation acquires a domestic corporation or partnership, the domestic corporation or partnership is subject to certain adverse tax consequences when its former equity owners own 60% or more of the foreign acquiring corporation. When such former equity owners own 80% or more, the foreign acquiring corporation is treated as a domestic corporation for U.S. federal income tax purposes. The Senate Proposals would expand the scope of the anti-inversion rules to apply to an acquisition of a US business of a foreign partnership, and would lower the ownership thresholds to more than 50% and at least 65%, respectively. The provision applies to taxable years ending after December 31, 2021 and any transaction completed after the date of enactment would be subject to revised thresholds.

  If enacted, this provision could have a significant effect on the cost, structure, and viability of future cross-border M&A transactions. The House Bill did not contain a similar provision.

III. Individual and Partnership Tax Measures

- **Expand the 3.8% tax on net investment income.** Currently, limited partners who materially participate in a partnership's business are not subject to self-employment tax, and S corporation members who materially participate in an S corporation's business are subject to self-employment tax only on "reasonable compensation" that they receive in their employee capacity. These individuals also are exempt from the 3.8% tax on net investment income under section 1411, which currently applies only to certain passive income and gains.

For tax years beginning after 2021, the BBBA would subject all trade or business income of individuals earning over $400,000 (in the case of single filers) or $500,000 (in the case of joint filers) to the net investment income tax, unless that income is subject to self-employment tax.

- **Impose a 3-5% surtax on high-income earners.** Beginning after 2021, the BBBA would impose a new 5% tax on a taxpayer's modified adjusted gross income in excess of $10,000,000 ($5,000,000 for a married individual filing separately) and an additional 3% tax (for a total of 8%) on a taxpayer's modified adjusted gross income in excess of $25,000,000 ($12,500,000 for a married individual filing separately).

- **Expand the wash sale rules.** Section 1091(a) currently disallows a deduction for a loss realized from the sale or other disposition of stock or securities (or contracts to buy or sell stock or securities) if, within thirty days, the taxpayer acquires substantially identical stock or securities (or contracts).

  Beginning after 2021, the BBBA would expand the scope of the wash sale rules to include foreign currencies, commodities, digital assets such as cryptocurrencies, and contracts to buy or sell these assets.

  Business needs exception. The wash sale rules would not apply to foreign currency and commodity trades that are directly related to the taxpayer's business needs (other than the business of trading currencies or commodities) or are part of certain identified hedging transactions. The lack of a business needs exception for digital assets could be problematic for businesses that transact in these assets, although a number of commentators believe that bitcoin and ether are commodities. If the BBBA were enacted in its current form, commodity traders that have not already done so might want to consider making an election under section 475 to "mark to market" their assets each year and treat any resulting gain or loss as ordinary in nature; the wash sale rules do not apply to mark-to-market taxpayers.

  Related parties. The wash sale rules also would apply when a "related party" acquires substantially identical specified assets within the thirty-day wash sale window. For this purpose, related parties generally include (1) the taxpayer's spouse and dependents, (2) individuals or entities that control or are controlled by the taxpayer or the taxpayer's spouse or dependents, and (3) certain retirement and tax-advantaged accounts of the taxpayer or the taxpayer's spouse or dependents.

  Basis adjustment. The BBBA would preserve any losses disallowed by the wash sale rules on an acquisition by the taxpayer or the taxpayer's spouse by adding the disallowed losses to the acquirer's basis in the asset. However, losses disallowed as a result of other related party acquisitions would be permanently disallowed.

- **Limit gain exclusion on sales of qualified small business stock.** Section 1202 currently allows noncorporate taxpayers to exclude up to 100% of their gain on a sale of certain "qualified small business stock" held for more than five years. The BBBA would eliminate the 100% exclusion rate for individuals with adjusted

gross income of at least $400,000 and for all trusts and estates. Instead, these taxpayers would be eligible for only up to a 50% exclusion. This change would apply for sales occurring on or after September 13, 2021, unless the sale occurs in 2021 pursuant to a binding contract entered into on or before September 13.

- **Withhold on partnership derivatives.** Section 871(m) currently imposes a 30% withholding tax on U.S.-source "dividend equivalent payments" under securities loans, repos, and certain high-delta swaps and other derivatives. The BBBA would expand the withholding tax to "income equivalent payments" under high-delta swaps on (1) publicly traded partnerships and (2) "any other partnership as the Secretary by regulation may prescribe." An income equivalent payment would be any payment that is "determined by reference to income or gain in respect of" the partnership, or any other payment that the IRS determines is "substantially similar." The BBBA would also grant regulatory authority to issue regulations to apply this regime to repos and securities loans.

  The BBBA's proposal would be very difficult for taxpayers to administer. A partnership discloses an investor's allocable share of U.S.-source dividends on Schedule K-1. The partnership is not required to provide Schedule K-1 to investors until the due date for filing the partnership's tax return, which may be later than the date that payments are required to be made on a repo or swap that references the partnership. Moreover, the payer under a swap might not actually own the referenced partnership interest, and thus might not even have access to the partnership's Schedule K-1. Accordingly, parties might have to avoid entering into swaps that reference partnership interests, feel compelled to over-withhold on those swaps, or demand indemnification for any liability they incur for under-withholding.

- **Modify the rules for worthless partnership interests.** Subject to satisfying certain evidentiary burdens, taxpayers may claim a deduction under current section 165(a) for partnership equity that becomes worthless during the taxable year. Taxpayers typically treat partnership equity worthlessness deductions as capital losses if they have a share of partnership liabilities (because a shift of partnership liabilities in connection with a partner's departure results in a deemed sale), but otherwise claim ordinary losses.

  Beginning after 2021, the BBBA would apply deemed sale treatment to all partnership equity worthlessness deductions, so that taxpayers would have capital losses instead of ordinary losses except to the extent the deemed sale is attributable to inventory or other "hot assets." The BBBA also would revise section 165(g), which governs deductions for worthless corporate securities, to treat partnership debt as "securities" and to treat all worthless securities deductions as arising at the time of the identifiable event establishing worthlessness instead of at the end of the year.

- **Expand the constructive sale rules.** Section 1259 currently treats a taxpayer as having sold an appreciated position in stock, partnership equity, or certain debt if the taxpayer or a related person enters into certain offsetting transactions. Beginning after the date of enactment, the BBBA would expand these rules to cover digital assets, and would provide that an appreciated short sale, short swap, or short forward or futures contract is constructively sold when the

taxpayer enters into a contract to acquire the reference property (not just when the taxpayer actually acquires the reference property, as under current law).

- **Apply section 163(j) at the partner level.** As mentioned above, section 163(j) generally allows a deduction for business interest expense only to the extent that it exceeds business interest income plus 30% of EBITDA (or EBIT, beginning after 2021). Currently, section 163(j) applies both at the partnership and partner levels. The BBBA would amend section 163(j) so that it applies only at the partner level.
- **Increase the SALT deduction limitation.** The TCJA capped the deductibility of personal state and local taxes against a taxpayer's federal tax liability at $10,000 through 2025. The House Bill would increase the deduction to $80,000 for tax years beginning after 2020. The limitation would sunset at the end of 2031. The Senate Proposals do not specify an amount at which deductions would be capped.

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