Revised Build Back Better bill - Key provisions impacting asset and wealth management

November 9, 2021

In brief

The House is expected to vote the week of November 15 on a revised version of the Build Back Better reconciliation legislation (the bill). The revised legislation reflects changes made by the House Rules Committee on November 3 (through a substitute amendment) and a “chairman’s amendment” offered by House Budget Committee Chairman John Yarmuth (D-KY). Any House-passed version of the bill is expected to be revised in the Senate, which would require further House action.

The bill calls for roughly $1.75 trillion in new federal spending, targeting tax relief provisions and ‘green energy’ tax incentives. The Joint Committee on Taxation staff have estimated that the business, international, and individual tax increases in the bill would raise more than $1.5 trillion over 10 years. Additional offsets would include increased IRS enforcement measures and savings for the repeal of a Medicare prescription drug rule. The bill also includes a provision to raise through 2030 the cap on the individual itemized deduction for state and local taxes.

Outlined below is an analysis of some of the key provisions of the bill affecting hedge funds, private equity funds, real estate funds, and other stakeholders in the asset management industry.

Observation: Investment managers should continue to monitor the status of the reconciliation legislation and consult with advisors on how particular provisions may impact their fund structures and investments.

In detail

Provisions dropped from initial reconciliation bill include revisions to carried interest, tax rate increases

The revised bill drops several key provisions of the bill as approved September 15 by the House Ways and Means Committee. In particular, proposed revisions to the existing carried interest rules under Section 1061 were removed in their entirety. Other provisions that were removed include a 26.5% top corporate income tax rate, a 39.6% top individual income tax rate, and a 25% long-term capital gains and qualified dividend tax rate, as well as proposed
revisions related to the 20% Section 199A deduction for pass-through income, the estate and gift tax exemption, grantor trusts, and certain restrictions on the types of investments permitted to be held in retirement savings accounts.

**Observation:** The carried interest provisions in the Ways and Means bill were viewed as a significant expansion of the application of Section 1061. While the removal of these provisions may come as welcome news to the industry, the possibility remains for Congress to target carried interest in future legislation, along with the possible revival of state-specific legislation that has been proposed in the past due to perceived federal inaction.

**Observation:** While the expansion of the carried interest rules was not included in the revised bill, Section 1061 remains in effect, and the final Section 1061 regulations are effective for tax years beginning on or after January 19, 2021 (January 1, 2022 for calendar-year taxpayers). Taxpayers should continue to address relevant Section 1061 issues before year-end. For prior coverage on the impact of the final Section 1061 regulations, please see our Insight "Final Section 1061 regulations provide significant changes".

**New surcharge on high-income individuals, estates, and trusts**

The bill creates a new 5% surcharge on an individual’s modified adjusted gross income in excess of $10 million ($5 million for a married individual filing separately), and an additional 3% surcharge (for a total of 8%) on a taxpayer’s modified adjusted gross income in excess of $25 million ($12.5 million for a married individual filing separately). For individuals, “modified adjusted gross income” means adjusted gross income reduced by any deduction (not taken into account in determining adjusted gross income) allowed for investment interest. Modified adjusted gross income does not include any below-the-line deductions, such as the charitable deduction, mortgage interest deduction, and the state and local tax deduction. In addition, it would not include the 20% Section 199A deduction, as that is an adjustment in arriving at taxable income. The surtax also would apply to nonresident alien individuals, but only to the extent of their income that is effectively connected with a US trade or business.

**Observation:** Since modified adjusted gross income does not include below-the-line deductions, taxpayers should consider the availability of elective entity-level state tax regimes to provide for a potential above-the-line deduction of state and local income taxes. Specified income tax payments deducted above-the-line on Schedule E would be deductible when calculating a taxpayer’s modified adjusted gross income, whereas any state and local tax payments deducted below-the-line would not be deductible when figuring the surcharge.

For estates and trusts, the new 5% surcharge applies to adjusted gross income in excess of $200,000, with an additional 3% surcharge applying on adjusted gross income in excess of $500,000. For purposes of this provision, an estate or trust’s “adjusted gross income” is determined as provided under Section 67(e) but reduced by any charitable deduction allowed under Section 642(c). Under Section 67(e), adjusted gross income is determined by subtracting the following items from the estate or trust's gross income: the administration costs of the estate or trust (that would not have been incurred if the property were not held by the estate or trust), the income distribution deduction, the allowable exemption, and any NOL deduction claimed.

These changes would be effective for tax years beginning after December 31, 2021.

**Observation:** Wholly charitable trusts are excluded from the provision. Although not specifically excluded, it would seem that grantor trusts (as generally disregarded for federal income tax purposes) and charitable remainder trusts (which are tax exempt) would not be subject to the surcharge, but it would be helpful to have this clarified in regulations.

**Observation:** Estates and complex trusts may want to consider that the surcharge applies at much higher income thresholds relative to individuals than it does for estate or complex trusts.
Observation: Subject to certain limitations, individuals and trusts that are subject to the surcharge may be able to offset it with available foreign tax credits.

Corporate profits minimum tax

The new Corporate Profits Minimum Tax (CPMT) would impose a 15% alternative minimum tax (AMT) on the adjusted financial statement income (AFSI) of applicable corporations that report over $1 billion in profits to shareholders, while preserving the value of general business credits (e.g., the research tax credit) and allowing an AMT foreign tax credit. In addition, the provision would allow applicable corporations an indefinite carryforward of financial statement losses and an indefinite carryforward for an AMT credit to be claimed against regular tax in future years.

Under this new provision, an applicable corporation is a C corporation (excluding regulated investment companies (RICs) and real estate investment trusts (REITs)) with average annual AFSI that exceeds $1 billion for any three consecutive tax years of the corporation occurring during the period ending with the tax year that precedes such tax year and ending after December 31, 2019. Generally, adjusted financial statement income would include the financial statement income of certain related parties.

In addition, there are special rules for determining how the CPMT applies with respect to a US corporation with a foreign parent. In the case of foreign-parented corporations, the $1 billion three-year average annual AFSI requirement is determined by aggregating the AFSI for all members of the international financial reporting group in which the applicable corporation is a member. As a result, both US-parented and foreign-parented corporations are tested on their global income for purposes of this $1 billion requirement.

If the international financial reporting group of a foreign-parented corporation meets this $1 billion requirement, a corporation that is a member of that group is not treated as an applicable corporation unless it also meets the requirement for the AFSI of the US group. Under this requirement, in the same three-year period, the average annual AFSI of the US group must be $100 million or more. For purposes of determining the US group’s AFSI, all members under common control are aggregated, except the AFSI of a foreign corporation under common control is only included if the income is effectively connected to a US trade or business or the foreign corporation is a controlled foreign corporation (CFC).

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

Observation: The new CPMT is being proposed as a replacement for the Ways and Means Committee provision to increase the top US corporate income tax rate from 21% to 26.5% in response to Senator Krysten Sinema’s (D-AZ) objections to rate increases. For more information, please see our Insight ‘Revised Build Back Better bill - key business and individual tax provisions’.

Observation: While the thresholds appear to be high for most alternative fund structures, the related-party rules could result in impacting some structures with corporate blockers (and possibly even portfolio companies) that are owned by foreign corporate feeders and considered under common control and which collectively, meet the financial statement income thresholds.

Observation: In addition, in light of the proposed changes to Section 52, which would provide that a “trade or business” includes any activity engaged in for the production of income, the common control test might be deemed met if a partnership controlled the corporate blockers or portfolio companies. In that case, such group would need to be analyzed in order to determine whether the CPMT is applicable.
Scope of Net Investment Income Tax (NIIT) expanded

The NIIT imposes a 3.8% tax on “net investment income” of individuals, estates, or trusts that have modified adjusted gross income (MAGI) above defined statutory thresholds. Net investment income generally includes interest, dividends, capital gains, rental and royalty income, nonqualified annuities, and income from businesses that are passive activities to the taxpayer.

The bill would expand the scope of the NIIT to cover “specified net income” derived in the ordinary course of a trade or business for taxpayers with greater than $400,000 in taxable income (single filer) or $500,000 (joint filer), as well as for trusts and estates for income in their top tax rate. Specified net income generally includes net investment income plus other gross income derived from a trade or business, reduced by deductions properly allocable to such income. The provision indicates that the NIIT would not be assessed on income on which FICA already is imposed.

**Observation:** Essentially, this change would subject all earnings from pass-through businesses to either the 3.8% self-employment Medicare tax or the 3.8% NIIT, regardless of whether the income is from a passive or nonpassive activity. For example, materially participating partners in management companies structured as limited partnerships, who previously were not subject to the NIIT on their distributable income, would now be subject to the NIIT.

**Observation:** Since the NIIT is not deductible, while the self-employment Medicare tax is 50% deductible and is calculated on 92.35% of applicable income, it is generally more preferable to have a dollar subject to self-employment tax versus NIIT. Managers may evaluate the impact of changing to an entity whose income is subject to the self-employment Medicare tax instead of the NIIT, while also considering other factors (e.g., state and local tax profile).

In addition, under current law, taxpayers are eligible to include any net operating loss (NOL) deduction allowed under Section 172 as a properly allocable deduction against net investment income (to the extent the amount of the net operating loss only includes items of gross income and deduction taken into account in determining net investment income). The bill provides that NOLs no longer would be taken into account as a properly allocable deduction against net investment income.

The bill also would make changes to the definition of “net investment income” to include certain deemed foreign income items such as subpart F inclusions, GILTI, qualified electing fund inclusions, and mark to market income, when they are includible as income for regular tax purposes.

**Observation:** This provision would cause any deemed foreign income items included in the taxpayer’s gross income for regular tax purposes to be treated as net investment income concurrently in the same tax year, irrespective of whether such amounts were distributed, and regardless of whether the US taxpayer had an election under Treas. Reg. sec. 1.1411-10(g) in effect to pay NIIT in the same year as income is included for regular tax purposes. If enacted, US taxpayers no longer would be able to defer the recognition of controlled foreign corporation (CFC) and qualified electing fund (QEF) inclusion amounts for NIIT purposes. US taxpayers will also need further clarity from the IRS and Treasury addressing distributions of previously taxed income.

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

Excess Business Loss deduction for noncorporate taxpayers limited

The 2017 tax reform act added Section 461(l) to limit the deduction of business losses incurred by noncorporate taxpayers. Section 461(l) disallows a deduction for the amount of business losses in excess of $250,000 ($500,000 for joint filers), indexed for inflation, attributable to a trade or business in which the taxpayer actively participates. Under the 2017 act, Section 461(l) is scheduled to expire after 2025.
The CARES Act repealed the excess business loss limitation rules for tax years beginning before 2021, including with retroactive effect for all years to which Section 461(l) applied (previously, Section 461(l) applied to tax years beginning after 2017).

Under the bill, Section 461(l) would be amended to disallow excess business losses (i.e., net business deductions in excess of business income above the specified thresholds) for noncorporate taxpayers for tax years beyond 2025. In addition, the carryforward losses no longer would be considered an NOL. Instead, taxpayers whose losses are disallowed may carry those losses forward to succeeding tax years where they would be treated as excess business losses incurred in such future years and considered as part of the $250,000 or $500,000 (adjusted for inflation) limitation for that year. The amendments made by this section would apply to tax years beginning after December 31, 2020. By comparison, management companies of trader funds that operate at a loss can offset management company losses with trading income.

Observation: This provision would be retroactive and apply to excess business losses occurring in 2021. However, as the current Section 461(l) already limits excess business losses to $250,000 or $500,000 (adjusted for inflation) for 2021, this should not affect estimated taxes paid for 2021.

Observation: This is a significant provision for management companies (of investor funds) that are operating at a loss. Managers cannot offset the loss against income or gain from the investor fund, and therefore the loss is an excess business loss to the extent it exceeds trade or business income from other sources plus $250,000, or $500,000 for joint filers. The ability under current law to convert the excess business loss into an NOL effectively creates a one-year timing difference. The new provision could indefinitely defer recognition of the excess business loss until the management company is profitable or the loss otherwise is offset against other trade or business income.

Observation: Unlike the rules for passive activity losses, which accelerate suspended losses upon disposition of an interest in a passive activity, the excess business losses provision does not accelerate suspended losses upon disposition of a trade or business and would only be available to offset other trade or business income from other sources.

Modification to the portfolio interest exemption

For purposes of disallowing the portfolio interest exemption for interest received by a “10-percent shareholder,” the bill would expand the definition of “10-percent shareholder” with respect to corporations to include 10% ownership taking into account total combined voting power or total value of the stock of such corporation. This provision would apply to obligations issued after the date of enactment of the bill.

Observation: The change is expected to narrow the eligibility for the portfolio interest exemption and could have an impact on foreign investors in offshore credit funds or other leveraged “blocker” structures. Debt issued prior to enactment of the bill would be grandfathered; thus, taxpayers should be careful when modifying any debt to the extent such debt may lose its grandfathered protection.

Dividend equivalent amounts (DEA) on derivatives referencing publicly traded partnerships

The bill would amend Section 871(m) to provide that certain payments pursuant to specified notional principal contracts (specified NPCs) with respect to publicly traded partnerships (PTPs) are treated as dividend equivalents and subject to 30% withholding tax (or lower under an applicable treaty). The bill provision is generally consistent with the House Ways and Means Committee provision, with various clarifying changes.
Most significantly, the amendments made by this provision would apply to payments made after December 31, 2022 (instead of 180 days after enactment, as originally contemplated).

In general, the provision would treat any payment on a specified NPC as giving rise to a DEA to the extent such payment is directly or indirectly contingent upon or determined by reference to any income or gain in respect of the underlying PTP. The bill clarifies that income or gain includes any income or gain from the deemed disposition of the partnership interest (using Section 864(c)(8) principles, i.e., a deemed sale of the partnership’s assets at fair market value, without regard to a provision that excludes FIRPTA gain from Section 864(c)(8)) as a result of the termination of, or upon any payment with respect to, the specified NPC. Additionally, other U.S.-sourced income of the PTP, including any fixed or determinable annual or periodical income (FDAP), e.g., interest, dividends, rents, etc., is further treated as income or gain for purposes of calculating the DEA.

Treasury would be granted specific regulatory authority to carry out the purposes of the provision, including regulations extending the dividend equivalent treatment to payments under sale-repurchase agreements, securities lending transactions, or other derivatives.

**Observation:** In addition, if enacted, these new rules would be effective for existing swaps on payments made beginning in 2023 (i.e., no grandfathering protection).

**Observation:** The provision is broadly drafted, apparently designating interest and other FDAP income as dividend equivalents, as well as gain (including FIRPTA gain) on the deemed sale of a partnership interest upon any payment on, or termination of, the specified NPC.

**Observation:** Taxpayers will need further clarity on how this provision would apply. While gain is specifically determined using Section 864(c)(8) principles, it is unclear how to apply those principles in the PTP context. Additionally, the IRS will need to provide guidance on how to calculate the amount of a "payment" on a swap. Under Section 871(m) generally, the term may be interpreted quite broadly. However, the application of this concept is generally somewhat clearer intuitively since a DEA is generally intended to track the amount of the underlying dividend. In this context, it is likely to be much more difficult to calculate the underlying income or gain in respect of a PTP over a particular period of time for each individual and unique investment.

**Observation:** Treasury is provided specific authority to require PTPs to provide necessary information to help withholding agents calculate the potential dividend equivalent amounts. Even if such guidance is issued, it may be a challenge for a PTP to provide information in a manner that is sufficient and useful for purposes of allowing withholding agents to reduce potential withholding tax under this provision.

**Modifications related to the determination of status as a CFC**

The bill would restore former Section 958(b)(4), which prevented downward attribution of stock owned by a foreign person to a US person. Thus, when applying the downward attribution rules, there would be no stock ownership attribution from such a non-US person to a partnership, trust, estate, or corporation in which the non-US person owns an interest. This change would be effective for the last tax year of foreign corporations beginning before January 1, 2018, and each subsequent tax year of such foreign corporations.

Further, the provision allows for US shareholders of foreign corporations (e.g., 10/50 companies) to elect to be treated as CFCs.

**Observation:** The provision to restore the former Section 958(b)(4) on a retroactive basis (for certain purposes) generally is expected to address certain unintended adverse consequences that arose from its repeal under 2017 tax reform, namely, the intricacies and complexities, which reached beyond the intent described in the 2017 legislative history with respect to the repeal of downward attribution, and resulted in consequential information...
reporting. The actual impact of this provision for each taxpayer would need to be further analyzed. Nevertheless, in certain cases, we expect it to provide welcome relief as it reduces the extent of constructive CFCs and US shareholders and, consequently, the income inclusions (subpart F, GILTI, and Section 965) of US persons in complex fund structures. If the provision is enacted on a retroactive basis, US taxpayers who had income inclusions under the CFC anti-deferral rules that otherwise would not have had inclusions but for the repeal of Section 958(b)(4) could seek to amend previously filed tax returns.

Modification of the limitation on deduction of business interest expense

Section 163(j) currently applies the limitation on the deduction of business interest expense at the partnership level. If a partnership has deductible business interest expense, the deductible business interest expense is not subject to further Section 163(j) limitations at the partner level. The partnership’s excess business interest expense is allocated to the partners to be carried forward at the partner level indefinitely.

The bill would amend Section 163(j) to apply the interest limitation at the partner level, instead of at the partnership level, effective for tax years beginning after December 31, 2022. Under a transition rule, excess business interest expense allocated to a partner by a partnership under current law that is carried over to a tax year beginning after December 31, 2022 would be treated as business interest paid by the partner.

Observation: The provision takes an aggregate approach to the interest expense limitation with respect to partnerships, which could simplify the complex rules that currently apply. The impact of this change could vary depending on each partner’s and partnership’s particular facts. For example, a partner could have losses from other sources that reduce its overall adjusted taxable income (its capacity to deduct interest), possibly limiting the deductibility of interest expense that may have been permitted if tested at the partnership level. Alternatively, a partner may benefit by using income from other sources to create capacity to deduct interest expense incurred at the partnership level that may have been limited if tested at that level.

The bill also would add new Section 163(n), which limits the interest deduction of certain domestic corporations and foreign corporations engaged in a US trade or business in proportion to their share of the total earnings of their international financial reporting group (IFRG). The limitation generally applies to C corporations whose average net excess interest expense over a three-year period exceeds $12 million, and there are one or more foreign corporations included in the applicable financial statement of the domestic corporation or an election is made to include them as part of the IFRG. This limitation generally equals 110% of the domestic corporation’s share of the group’s net interest expense (determined by reference to EBITDA). This is intended to prevent corporate groups from shifting a disproportionate amount of their interest deduction to the United States in order to lower their US tax liability (a practice known as “earnings stripping”).

The bill includes a new grant of authority to Treasury to issue regulations to treat subpart F income of a CFC, and any interest expense of such corporation that is related to such income, as income and interest expense, respectively, of a domestic corporation for purposes of this provision.

The bill would add Section 163(o), providing for an indefinite carryover of disallowed interest expense under Section 163(j)(1) or Section 163(n)(1) (whichever is lower).

Observation: This limitation, which is in addition to the rules under Section 163(j), has some similarities to the UK ‘debt ratio’ test which evaluates significant shifts in interest deductions in proportion to the worldwide debt (and lack thereof in lower-tax jurisdictions). As this could significantly impact a portfolio company's ability to put leverage in the United States, funds should evaluate the financing structures at their portfolio companies.

Observation: As currently drafted, there is no explicit language indicating that the limitation may apply to foreign corporations in calculating earnings and profits from a US tax perspective. Further, while foreign corporations with a
US trade or business can be considered as members of the IFRG, the language does not explicitly indicate how the rules would apply to such foreign corporations.

**Observation:** The original Ways and Means version of this provision would have limited carryforwards to five years. The new regulatory grant that directs Treasury to issue regulations to treat subpart F income as income of a domestic corporation for purposes of this provision also is a favorable change. It is notable, however, that the bill does not direct Treasury to provide similar treatment for GILTI, despite the fact that, under the bill's provisions, more than 70% of GILTI is subject to current US tax.

**Expansion of wash sale rules**

The bill would expand the types of assets subject to the wash sale rules to include commodities, foreign currencies, and digital assets (including contracts or options to acquire or sell these assets). The definition of digital assets is the same as under the Senate-passed infrastructure bill, consistent with the proposed amendment to the constructive sales rules.

An exception is provided for any sale or disposition of a foreign currency or commodity that is directly related to the business needs of a trade or business of the taxpayer -- other than the trade or business of trading foreign currencies or commodities -- or is part of a hedging transaction within the meaning of Section 1221(b)(2).

The bill would expand the wash sale rules to cover acquisitions by related parties. Related parties include an individual, corporation, partnership, trust, or estate that controls or is controlled by (within the meaning of Section 954(d)(3)) the taxpayer, among others. The bill directs Treasury to issue regulations to treat persons as related parties if the persons are formed or availed of to avoid the purposes of the wash sale rules.

**Observation:** The bill would retain essentially all the wash sale provisions in the earlier House Ways and Means Committee bill, and would expand the scope of the current law with respect to short positions and swaps (i.e., “notional principal contracts”). One result would be that the wash sale rules as applied to short positions now appear to be broader and therefore could apply to many of the same types of transactions as the rules for long positions. Considering this proposed expansion, taxpayers should review their trading strategies and monitor their positions accordingly.

The bill provides that if the taxpayer (or the taxpayer’s spouse) acquires substantially identical assets during the period that begins 30 days before the disposition at a loss (that was disallowed under the wash sale rules) and ends with the close of the taxpayer’s first tax year that begins after such disposition, the basis of such assets generally is increased by the amount of the loss disallowed. The bill does not provide for such a direct basis adjustment to the extent a related party (other than the taxpayer’s spouse) acquires substantially identical assets. Similarly, the bill does not appear to provide for a direct basis adjustment if the wash sale is caused by entering into a contract to acquire the substantially identical asset. Instead, the taxpayer could recoup the disallowed loss only via a basis credit if it acquires the same or substantially identical property beginning 30 days before the loss was disallowed and ending in the tax year following the year such loss is realized.

The provision would be effective for sales, dispositions, and terminations after December 31, 2021.

**Observation:** Complex basis “hopping” rules apply to effectively transfer the loss to the acquired property. In general, a wash sale will result in permanently disallowed loss if the new position is acquired by a related party (other than a spouse). It also appears that if a taxpayer (or spouse) enters into a wash sale via a contract to acquire a substantially identical asset, the loss becomes permanently disallowed if the contract is not exercised before the end of the following tax year. Since the basis credit may be obtained by acquiring the same or substantially identical property through the following year, taxpayers should monitor these positions to reduce the risk of a permanent disallowance resulting from a wash sale.
Expansion of constructive sales rules to digital assets

The bill would expand the definition of “appreciated financial position” in the Section 1259 constructive sale rules to include positions with respect to “digital assets.” The bill also would amend Section 1259(d) by adding a definition — subject to alteration by regulations — of the term “digital asset,” which would include “any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary.”

Furthermore, the types of transactions that may result in a constructive sale of certain appreciated economic short positions with respect to property would be amended to include entering into a contract to acquire the same or substantially identical property.

The bill adds an exception for contracts to sell digital assets that are not similar to “marketable securities” (defined in Section 453(f)). These changes would be effective for constructive sales that occur, or for contracts entered into, after the date of enactment.

Observation: The term “digital asset” has not been used previously in either the Internal Revenue Code (the Code) or the regulations. The proposed definition is the same as in the infrastructure bill passed by the Senate on August 10, 2021 and by the House on November 5. The proposed statutory text provides fairly broad discretion to the Treasury Department to modify the definition by qualifying it with the language “except as otherwise provided by the Secretary” and directing Treasury to specify “any similar technology.”

Observation: The exception added in the bill to prevent contracts to sell digital assets that are not similar to “marketable securities” requires a closer look into the nature of each specific digital asset being contracted to be sold.

Excise tax on corporate stock repurchases

The bill would impose a 1% excise tax on a publicly traded US corporation for the value of any of its stock that is repurchased by the corporation during the tax year.

A ‘repurchase’ is defined as a redemption within the meaning of Section 317(b) with regard to the stock of such corporation, and any other economically similar transaction as determined by Treasury. A ‘specified affiliate’ of a publicly traded US corporation that performs the buyback of the stock of the publicly traded US corporation also is subject to the excise tax. A ‘specified affiliate’ means, with respect to any corporation, (1) any corporation more than 50% of the stock of which is owned (by vote or value), directly or indirectly, by such corporation; and (2) any partnership more than 50% of the capital interests or profits interests of which is held, directly or indirectly, by such corporation. The amount of repurchases subject to the tax is reduced by the value of any stock issued by the corporation during the tax year, including stock issued to the employees of the corporation or a specified affiliate of such corporation during the tax year.

The provision also includes special rules for foreign-parented domestic corporations, which would treat a repurchase of stock by certain affiliates of a publicly traded foreign corporation (including domestic corporations, domestic partnerships, and foreign partnerships with domestic partners) as if it were a repurchase by a publicly traded US corporation.

There are various exceptions to this tax, including among others, a repurchase that is part of a reorganization under Section 368(a) where no gain or loss is recognized by the shareholder, a repurchase by a dealer in securities or by a RIC/REIT, and to the extent the repurchase is treated as a dividend.

The provision would apply to repurchases of stock after December 31, 2021.
Limitation on the exclusion for gain of certain small business stock

Under current law, taxpayers other than corporations may exclude between 50% and 100% of the gain from the sale of qualified small business stock acquired at original issue so long as it has been held for at least five years (the ‘50% exclusion rule’), subject to certain limitations and regardless of their gross income. The exclusion also may apply to gain recognized by certain pass-through entities to the extent allocated to taxpayers other than corporations. After February 17, 2009 but before September 28, 2010 the relevant exclusion percentage is 75% (the ‘75% exclusion rule’); in the case of stock acquired after September 27, 2010, the relevant exclusion percentage is 100% (the ‘100% exclusion rule’).

The provision would eliminate the special 75% and 100% exclusion rates for taxpayers with AGI equal or exceeding $400,000 or for any trust or estate (at any income level). Taxpayers not eligible for the enhanced exclusion percentages still could benefit from the qualified small business stock exclusion but would be limited to the 50% exclusion rule.

The amendments made by this provision would apply to sales and exchanges on or after September 13, 2021, subject to a binding contract exception.

Observation: While trusts are limited to the 50% exclusion rate, stock held through grantor trusts, which are disregarded for federal income tax purposes, presumably still could qualify for the 75% and 100% exclusion rates if the grantor’s AGI is below $400,000.

Observation: In accordance with the 50% exclusion rule, taxpayers who no longer qualify for the 75% and 100% exclusion rates would be taxed at a 28% capital gain rate on the taxable portion. Additionally, an amount equal to 7% of the amount excluded from gross income would be treated as a tax preference item for purposes of calculating a taxpayer’s AMT.

Modifications to treatment of worthless partnership interests

Under present law, a taxpayer, under certain circumstances, may recognize an ordinary loss if a partnership interest the taxpayer owns becomes worthless. The bill would provide that if a partnership interest becomes worthless, the resulting loss is treated as a loss from the sale or exchange of a capital asset at the time of the identifiable event establishing the worthlessness of the interest. As a result, a taxpayer that owns a worthless interest would recognize a capital loss except to the extent that the ‘hot asset’ rules of Section 751(a) apply (i.e., the partner’s share of the partnership’s unrealized receivable and inventory). The bill also expands the definition of securities for purposes of defining a worthless security to include a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a partnership.

The bill also acknowledges that abandonment can serve as an identifiable event for purposes of securing a worthless stock deduction under Section 165(g).

Observation: The bill generally would eliminate the possibility that a taxpayer could claim an ordinary loss for a worthless partnership interest or upon the writedown or write-off of debt issued by a partnership.

Individual Retirement Account (IRA) provisions

The bill contains several provisions addressing IRAs. These include, effective for tax years beginning after December 31, 2028, limiting contributions to Roth or traditional IRAs where the total account value exceeds $10 million, with mandatory distributions if that amount is exceeded. This would apply for single taxpayers (or married taxpayers filing separately) with taxable income over $400,000, married taxpayers filing jointly with taxable income over $450,000, and heads of households with taxable income over $425,000 (all indexed for inflation).
In addition, the bill adds back several prohibitions against Roth conversions for certain taxpayers. Taxpayers with qualified plans and IRAs where any portion of the account contains after-tax contributions would be prohibited from converting such amounts to a Roth account, regardless of the income level of the taxpayer. This provision would be effective for distributions, transfers, and contributions made after December 31, 2021. Separately, the proposal would no longer allow Roth conversions for both IRAs and employer-sponsored plans for single taxpayers (or married taxpayers filing separately) with taxable income over $400,000, married taxpayers filing jointly with taxable income over $450,000, and heads of households with taxable income over $425,000 (all indexed for inflation). This proposal would apply to distributions, transfers, and contributions made in tax years beginning after December 31, 2031.

**Observation:** The bill drops provisions from the September Ways and Means Committee bill that would have restricted the types of investments that can be held in an IRA (e.g., non-publicly traded entity in which the taxpayer owns a 10% or greater interest). If included, these provisions could have restricted fund managers from owning interests in their own funds through an IRA.

**Increase in the limitation on the itemized state and local tax deduction**

The bill, as amended on November 4, would increase the limitation on the itemized state and local tax deduction from $10,000 to $80,000 ($40,000 in the case of an estate, trust, or married individual filing a separate return), and would extend the increased limitation through 2030.

This provision would be effective for tax years beginning after 2020.

**Observation:** This provision was not included in President Biden’s “Build Back Better” framework nor in prior drafts of the bill. The revised bill initially would have proposed a cap of $72,500 ($36,250 in the case of an estate, trust, or married individual filing a separate return) through 2031, but the amount and expiration date were modified in a subsequent amendment prior to House vote.

**Observation:** Fund managers still should consider the potential benefits of a pass-through entity tax election. Despite the increase in the limitation on the state and local income tax deduction from $10,000 to $80,000, any state tax payments paid directly by the fund manager still may be limited and also would be considered an alternative minimum tax (AMT) preference item. Conversely, specified income tax payments paid by a pass-through entity and deducted above-the-line on Schedule E of the fund manager’s tax return would provide for a full deduction and not be subject to the application of AMT.

**Green energy qualified income for PTPs**

The bill expands the definition of qualified income for PTPs to include income derived from green and renewable energy. The additional qualified income includes income from certain activities related to energy production eligible for the production tax credit, property eligible for the investment tax credit, and renewable fuels, among others.

**IRS funding**

The bill would appropriate approximately $79 billion in funds for the IRS for taxpayer services, enforcement, operations support, and business systems modernization. The provision also provides $15 million for the IRS to prepare and deliver a report to Congress on the cost of developing and running a free direct efile tax return system. These appropriated funds, which would be available to the IRS until September 30, 2031, could not be used to increase taxes on any taxpayer with taxable income below $400,000.
Other international provisions

For information on additional international provisions that may be applicable to underlying investments (e.g., portfolio companies) as well as large management companies, please see our Insight ‘Revised Build Back Better bill - key business and individual tax provisions’.

Key notable provisions are:

- Changes to CFC rules:
  - A reduction in deduction for GILTI (applicable to corporate US shareholders or individual US shareholders making Section 962 elections) to 28.5% (from 50%) would result in a higher effective tax rate for GILTI.
  - Changes to the CFC rules introduced in the bill would be effective beginning after December 31, 2022 (rather than December 31, 2021).
  - The bill introduces regulatory authority and coordination with other provisions for Section 951A (GILTI) to tax years after the date of enactment.

- Modifications to pro-rata Subpart F determination for a US shareholder holding an interest in a CFC at any day of the tax year, effective for tax years beginning after December 31, 2021.

- Adjustments to earning and profits of CFCs, effective for tax years of foreign corporations ending after the date of enactment.

State and local tax considerations

The state and local tax impacts of the above provisions would vary depending on conformity to the Code. State and local adoption of the Code varies widely, but is generally on a rolling basis, a fixed-date basis, or select provision conformity. To the extent a jurisdiction does not adopt the Code on a rolling basis (i.e., upon enactment of the bill), there would be varying conformity dates which will add complexities and traps for the unwary. Most of the above provisions, outside of the rate changes, ultimately would impact the calculation of state and local income/loss and require an in-depth analysis.
Let's talk

If you have questions about how these tax provisions may affect you, please contact:

**Tax Policy Services**

Rohit Kumar  
(202) 841-8300  
rohit.kumar@pwc.com

Pam Olson  
(703) 627-8925  
pam.olson@pwc.com

Janice Mays  
(202) 603-0641  
janice.a.mays@pwc.com

Todd Metcalf  
(202) 304-5383  
todd.metcalf@pwc.com

Mark Prater  
(202) 826-9014  
mark.a.prater@pwc.com

**Asset and Wealth Management**

Kara Friedenberg  
(917) 648-5667  
kara.l.friedenberg@pwc.com

Jay Klein  
(347) 697-8246  
jay.j.klein@pwc.com

Alan Biegeleisen  
(917) 930 3887  
al Alan biegeleisen@pwc.com

**Mergers and Acquisitions - Real Estate**

Adam Feuerstein  
(240) 476-2647  
adam.s.feuerstein@pwc.com

**Mergers and Acquisitions - Partnerships**

Michael Hauswirth  
(202) 213-2729  
michael.j.hauswirth@pwc.com

Audrey Ellis  
(202) 834-4168  
audrey.ellis@pwc.com

Todd McArthur  
(202) 308-9475  
todd.y.mcarthur@pwc.com

**Private Equity**

Puneet Arora  
(917) 593-3803  
puneet.arora@pwc.com

Steve Puzzi  
(617) 835-9913  
stephen.puzzi@pwc.com

Winnie Tang  
(917) 828-2169  
winnie.t.tang@pwc.com

**Personal Financial Services**

Frank Graziano  
(617) 372-6462  
frank.graziano@pwc.com

Claudio DeVellis  
(516) 428-4116  
claudio.devellis@pwc.com

Irene Estrada  
(703) 628-5243  
irene.c.estrada@pwc.com

**State and Local Asset and Wealth Management**

Caragh DeLuca  
(732) 261-4243  
caragh.deLuca@pwc.com

Brian Rebhun  
(732) 267-6371  
brian.rebhun@pwc.com

Benjamin Luedeke  
(562) 682-3434  
benjamin.luedeke@pwc.com