Revised Build Back Better bill—key business and individual tax provisions

October 31, 2021

In brief

President Biden on October 28 announced a “Build Back Better” framework that outlines spending provisions described as costing $1.75 trillion over 10 years and revenue offsets believed to add up to nearly $2 trillion over the same period. The proposed revenue offsets include significant business, international, and individual tax increases, increased IRS enforcement measures, and repeal of a Medicare prescription drug rebate rule.

The framework provisions have been incorporated by the House Rules Committee into a revised version of the Build Back Better reconciliation legislation that was reported in September by the Ways and Means Committee and other House Committees. While Democratic House leaders have indicated that further changes -- including the possible addition of a provision addressing the cap on the individual itemized deduction for state and local taxes -- may be made to the legislation, the full House could vote soon on the revised bill and its tax increase provisions.

The revised bill’s significant business and international provisions include a new 15% corporate profits minimum tax on large corporations, a new 1% tax on corporate stock repurchases, limitations on interest deductions of international financial reporting groups, modifications to inbound and outbound international provisions -- including global intangible low-taxed income (GILTI), foreign-derived intangible income (FDII), foreign tax credit rules, the base erosion and anti-abuse tax (BEAT), and subpart F income -- and the extension of expensing (i.e., current deduction) of research and experimental costs under Section 174 through the end of 2025.

Individual tax increase provisions in the revised bill include a new surtax on high-income individuals and trusts, expansion of the net investment income tax, limitations on qualified small business stock exclusions, wash sale rules on cryptocurrency, and continuation of a temporary current-law limitation on excess business losses.

In line with the framework, the revised bill drops key tax rate increase provisions of the Ways and Means bill, including proposals that called for a 26.5% top corporate income tax rate, a 39.6% top individual income tax rate, and a new 25% long-term capital gains and qualified dividend tax rate. Additional Ways and Means proposals that were dropped include provisions related to carried interest, the 20% Section 199A deduction for pass-through income, the estate and gift tax exemption, grantor trusts, and retirement savings accounts.

Below is an analysis of key business and individual provisions proposed as part of the revised Build Back Better bill (the bill). A chart summarizing effective dates in the bill is set forth at the conclusion of this Insight.
Note: The tax provisions discussed below may be subject to significant changes as part of a “manager’s amendment” expected to be offered during House floor action on the legislation.

In detail

Background

President Biden and Democratic Congressional leaders are working to gain the support of all 50 Democratic Senators and nearly all House Democrats for the revised Build Back Better bill. Key changes in the legislation previously approved by the Ways and Means Committee and other House committees have been made in response to objections from Senator Krysten Sinema (D-AZ) to increasing the marginal tax rates for corporate, individual, and capital gains income and objections from Senator Joe Manchin (D-WV) to certain spending provisions.

The Build Back Better reconciliation legislation is being considered under a fiscal year 2022 budget resolution that provides reconciliation instructions. Legislation considered in the Senate under budget reconciliation instructions is subject to limits on the overall time for debate and can be passed by a simple majority (allowing the Vice President to cast a tie-breaking vote), instead of the 60-vote majority required to limit debate for most legislation.

Observation: The need to gain the unanimous support of all 50 Democratic Senators and avoid losing the support of more than three Democrats in the narrowly divided House has increased the challenge for President Biden and Democratic Congressional leaders to advance the Build Back Better bill over the objections of Congressional Republicans. At the same time, Democratic Congressional leaders have expressed confidence that they ultimately will deliver a final bill to President Biden for his signature before the end of the year.

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 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.

Observation: The new corporate profits minimum tax is being proposed as a replacement for the Ways and Means Committee proposal to increase the top US corporate income tax rate from 21% to 26.5% in response to Senator Sinema’s objections to rate increases, as noted above. This new provision reflects a legislative proposal that was released on October 26 by Senate Finance Committee Chairman Ron Wyden (D-OR), Senator Elizabeth Warren (D-MA), and Senator Angus King (I-ME). It remains to be seen whether some smaller level of corporate income tax rate increase might be reconsidered as an alternative to this new corporate profits minimum tax, or in combination with it, as Congressional Democrats seek to ensure that the cost of the legislation is fully offset.

Under this new provision, an applicable corporation is a C corporation (excluding RICs and REITs) with average annual adjusted financial statement income 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, in the case of a corporation subject to US federal income tax that is a subsidiary of a non-US parent, the corporation itself (combined with certain subsidiaries) also must have an average annual financial statement income of at least $100 million.
**Observation:** As this provision has an effective date of tax years beginning after December 31, 2022, affected taxpayers would need to evaluate whether they exceeded the threshold during their three tax years beginning in 2020 through 2022. However, once a corporation is subject to the CPMT, it remains subject to it unless otherwise provided in Treasury regulations.

In general, the term "adjusted financial statement income" (AFSI) means, with respect to any corporation for any tax year, the net income or loss of the taxpayer set forth on the corporation’s applicable financial statement (AFS) for such tax year, adjusted for certain items including:

- Appropriate adjustments for differences between a financial statement and federal income tax reporting year.
- Adjustments for corporations that are not members of the federal income tax consolidated group to exclude AFS income and include dividends received and other amounts included in gross income (other than under Subpart F and GILTI) with respect to such corporations.
- Adjustments to include the pro rata share of net income or loss on the AFS of each CFC for which the taxpayer is a US shareholder, but not below zero. (Negative adjustments would be carried forward to the succeeding year.)
- Adjustments to take into account adjusted financial statement income of any disregarded entities (DREs) owned by the taxpayer that are not included on its AFS.
- Adjustments to disregard federal income taxes and foreign income taxes (if the foreign tax credit is claimed) that are included in the AFS.
- Adjustments to reflect income earned from mortgage servicing rights in accordance with Section 451.

**Observation:** For purposes of computing AFSI, a taxpayer starts with its financial statement as defined in Section 451(b)(3), which for publicly traded companies would be its Form 10-K filed with the Securities and Exchange Commission.

**Observation:** As noted below, Treasury has the authority to include other adjustments, as appropriate. For example, it is unclear if financial statement unrealized losses, writedowns, and/or impairment losses will remain included in AFSI.

The provision would allow for the carryforward of a financial statement net operating loss (NOL), which generally follows the rules of Section 172 that limit an annual NOL deduction to the lesser of the NOL carryforward or 80% of the financial statement income. Only financial statement losses arising in tax years ending after December 31, 2019, would be permitted to be carried forward.

**Observation:** It is unclear how capital loss carrybacks would impact the annual computation and whether a taxpayer would have to recompute its CPMT in the carryback year.

**Observation:** Multinational companies will need to consider the complicated dividend rules set forth in the provision, which, as currently drafted, may result in double counting of income with respect to dividends from CFCs. Furthermore, as currently drafted, it appears that the alternative minimum tax foreign tax credit would apply (without a foreign tax credit limitation) to direct foreign income taxes and the taxpayer’s pro rata share of creditable foreign taxes from a foreign partnership. It appears that foreign taxes paid by CFCs would be creditable as well, but subject
to a foreign tax credit limitation equal to 15% of the taxpayer’s pro rata share of the adjusted financial statement income of its CFCs.

The provision provides authority to Treasury to issue guidance on a number of threshold issues, including:

- Providing a simplified method for determining whether a corporation satisfies the $1 billion and $100 million tests.
- Situations when it would be appropriate to exempt a corporation from the CPMT that otherwise should be subject to it.
- Providing adjustments to the determination of adjusted financial statement income as necessary to carry out the purposes of the provision.
- Guidance relating to the effect on partnerships with income taken into account by an applicable corporation.
- Application of the CPMT when a corporation has a change in ownership.
- Rules regarding the computation and utilization of financial statement NOL carryforwards.
- Guidance necessary to carry out the purposes of the alternative minimum tax foreign tax credit.

**Observation:** The proposed CPMT would add significantly to the complexity of corporate tax compliance and administration. As drafted, the provision introduces several new concepts and raises significant questions regarding their interpretation. As noted above, Treasury is granted broad authority to address these issues, including, in addition to the items noted above, authority to provide rules to prevent the omission or duplication of any item relevant to the determination of adjusted financial statement income. Because the CPMT will be effective for tax years beginning after December 31, 2022, Treasury is likely to issue guidance with respect to many of these issues prior to the provision becoming applicable to affected taxpayers.

**Surtax 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.

**Observation:** This provision was not included in the House Ways and Means Committee bill. Senator Sherrod Brown (D-OH) and Finance Chairman Wyden introduced legislation entitled the ‘Stock Buyback Accountability Act of 2021’ in September 2021. The provision is generally similar to the text of the Senate bill; however, that bill would have assessed a 2% excise tax instead of a 1% excise tax.

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. Additional rules apply if the foreign corporation is treated as a surrogate foreign corporation under Section 7874 as a result of a transaction completed after September 20, 2021.

The provision would not apply:

- to the extent the repurchase is part of a reorganization under Section 368(a) and no gain or loss is recognized on such repurchase by the shareholder;
- if the repurchased stock or its value is contributed to an employer-sponsored retirement plan, employee stock ownership plan, or similar plan;
- if the total value of stock repurchased during the tax year does not exceed $1 million;
- if the repurchase is by a dealer in securities in the ordinary course of business;
- to repurchases by a regulated investment company or real estate investment trust; or
- to the extent the repurchase is treated as a dividend.

The provision authorizes Treasury to issue guidance necessary or appropriate to administer and to prevent the avoidance of the purposes of this provision. The provision would apply to repurchases of stock after December 31, 2021.

Observation: If this provision is enacted, corporations considering stock buybacks would need to consider the impact of the excise tax in assessing the cost of the stock buyback. The applicability of the exceptions also will need to be considered. For example, the language of the provision seems to suggest that the excise tax could apply -- to some extent -- in all asset reorganizations involving a boot component, to the extent the boot does not result in dividend treatment. Further, corporations attempting to satisfy the exception for repurchases treated as dividends will need to determine whether the repurchases from each shareholder qualify for sale-or-exchange treatment or dividend treatment, typically a shareholder-level determination.

Interest expense of international financial reporting groups

The bill provides for new Section 163(n) to limit interest deductions of certain domestic corporations and foreign corporations that are engaged in a US trade or business and are members of an international financial reporting group. The limitation generally would apply only to C corporations with average excess interest expense over interest income includible over a three-year period exceeding $12 million.

The Section 163(n) limitation generally equals the domestic corporation’s interest income plus 110% of the domestic corporation’s share (determined based on a financial statement EBITDA ratio) of the group’s net book interest expense. 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.

Observation: As discussed further below, a separate provision of the bill significantly limits the allocation of expenses, including interest expense, to GILTI, a taxpayer-favorable change compared to current law. It is understood that the bill would be unlikely to include the taxpayer-favorable GILTI expense allocation changes unless the Section 163(n) interest limitation provisions described above are also included in the bill. Whether the
benefits of the taxpayer-favorable GILTI expense allocation rules outweigh the unfavorable effects of the new Section 163(n) provision will depend on the details of the final legislation and any subsequent guidance, as well as on each taxpayer’s specific facts.

The bill would amend Section 163(j) for partnerships and S corporations to apply at the partner and S corporation shareholder level and would provide special transition rules for partners in a partnership. The bill would apply an aggregate approach to partnerships and S corporations and proposes corresponding changes to Section 163(j)(4) to reflect a consistent aggregate approach. Similar to the Ways and Means bill, the provision is silent on whether the provision applies to CFCs.

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:** 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.

Sections 163(n) and 163(o) are proposed to apply to tax years beginning after December 31, 2022.

**Observation:** Unlike the Biden administration proposal, the provision would apply Section 163(n) to both US and non-US-based multinationals. A similar provision was included in both the House- and Senate-passed versions of the 2017 tax reform legislation but was dropped from the final act. Note also that the bill does not modify the pending change in the definition of ‘adjusted taxable income’ (ATI) in Section 163(j). For tax years starting on or after January 1, 2022, the definition of ATI would be calculated similar to EBIT, whereas under current law it is calculated similar to EBITDA.

**Observation:** Concepts similar to current law Section 163(j) and proposed Section 163(n) are found in the laws of other countries and are discussed in the OECD’s BEPS Action 4 Report. Under the OECD’s recommended approach, however, taxpayers could deduct interest expense based on which of the two limitations allowed for a greater interest expense deduction, while the bill would only permit deductions based on the lesser amount allowed under the two provisions.

**Observation:** Taxpayers should be aware of the various references to certain financial accounting concepts within the proposed legislation. Specifically, proposed Section 163(n) makes reference to financial reporting EBITDA, which reflects US GAAP and will differ in timing and treatment on some items from amounts as determined under US federal income tax principles. These potential differences between financial reporting and tax concepts may further impact a company’s interest deduction.

**Modifications to deduction for FDII & GILTI**

The bill would reduce the Section 250 deduction for FDII to 24.8% (from 37.5%), resulting in an effective rate of 15.8% on FDII, and the Section 250 deduction for GILTI (and the associated Section 78 gross-up amount) to 28.5% (from 50%). Combined with a 5% haircut on GILTI foreign tax credits (reduced from 20% under current law), this deduction would produce an effective tax rate on GILTI income of 15.8%. These changes to the Section 250 rates would be effective for tax years beginning after December 31, 2022; however, the bill includes a transition rule for tax years that include December 31, 2022, which would apply the reduced rate pro rata based on the number of days before and after December 31, 2022. Like the Ways and Means bill, the bill would remove the existing taxable income limitation on the Section 250 deduction and instead permit the Section 250 deduction to be taken into account in determining a taxpayer’s NOLs by striking current Section 172(d)(9).
The bill also would modify the definition of ‘deduction eligible income’ (DEI) by excluding (1) passive income as described in Section 904(d)(2)(B)(i) or (ii) (with certain modifications), (2) gains from the sale or other disposition of property giving rise to rents or royalties derived in the active conduct of a trade or business (except as otherwise provided by Treasury), and (3) disqualified extraterritorial income. The bill includes a corresponding change to the definition of “sale” in Section 250(b)(5)(E) such that the broad definition therein does not apply for purposes of the exclusion described above related to sales or dispositions of certain property. This change would apply to tax years beginning after the date of enactment.

Observation: The Ways and Means bill included several technical amendments identifying income that is excluded from the definition of DEI, including “any income received or accrued which is of a kind which would be foreign personal holding company income (as defined in section 954(c))”. The House Budget Committee report on the Ways and Means bill (H. Rpt. 117-130) clarifies that the relevant language in the Ways and Means bill is intended to exclude passive income, not active income. Consistent with the Committee report, the updated language in the bill explicitly excludes income that is passive for FTC purposes and thus does not apply to active royalty income. However, the exclusion of gains from the sale of property giving rise to rents or royalties derived in the active conduct of a trade or business is broader than the exclusion under the prior Ways and Means bill. The exclusion related to active rent and royalty-generating property includes a grant of authority to Treasury to provide exceptions that may limit the exclusion’s application for certain dispositions.

Modifications to inclusion of GILTI

The bill would require country-by-country application of the GILTI regime and generally would reduce to 5% from 10% the deemed tangible return on qualified business asset investment (QBAI) excluded from tested income. For qualified business assets located within a US territory, the deemed return would remain 10%. Other changes to the GILTI regime include an added ability to carry over a country-specific net CFC tested loss to succeeding tax years, and the elimination of the exception from tested income for foreign oil and gas extraction income (FOGEI). These changes would be effective for tax years of foreign corporations beginning after December 31, 2022.

Observation: Unlike the Biden administration’s and Senate Finance Committee’s proposals to repeal the QBAI exemption, the bill generally would allow a QBAI return of 5%. This is more closely aligned with the OECD’s Pillar Two proposal for a global minimum tax that includes a substance-based carve-out, but is more restrictive than the OECD approach in that it does not extend to payroll. In addition, the OECD approach provides for an initial 8% exemption for tangible property in the Pillar Two proposal with a transition to 5% over 10 years. Further, unlike the Biden administration proposal, the bill would allow losses to be carried forward, but, unlike the Pillar Two proposal, the bill would not extend this treatment to pre-regime losses.

Modifications to foreign tax credit limitation and related provisions

The bill would add new Section 904(e), which would require making foreign tax credit determinations within each of the separate limitation categories on a country-by-country basis for purposes of Sections 904(a) through (d), 907, and 960. This provision generally assigns each item of income and loss to a taxable unit of the taxpayer that is a tax resident of a foreign country (or has a taxable presence in a country in the case of a branch) and aggregates all taxable units that are subject to tax in the same country. The bill also would repeal the foreign branch income basket. In addition, the bill would repeal the specific allocation of foreign taxes imposed with respect to base differences to a separate limitation category and would replace the provision directing Treasury to provide guidance assigning such foreign taxes to a category of income.

Under the bill, the one-year foreign tax credit carryback would be eliminated and the 10-year foreign tax credit carryforward period would generally be retained for all separate limitation categories or baskets. This is a change from the prior Ways and Means Committee bill that would have reduced the foreign tax credit carryforward period
for all baskets to five years. The bill also would permit foreign tax credits in the GILTI basket to be carried forward, but subject to a special five-year limitation for taxes paid or accrued in tax years beginning after December 31, 2022, and before January 1, 2031, with the 10-year carryforward period applying thereafter.

As noted above in the discussion of section 163(n), the bill would provide that no US group expenses are allocable against GILTI inclusions, with the exception of the Section 250 deduction, state, local, or foreign income tax imposed with respect to the inclusions, and any other deductions that Treasury determines are directly allocable to such income. Any expenses that otherwise would have been allocable to the GILTI basket instead would be allocable to US source income. Further, the bill includes a special ordering rule that would create a separate limitation loss account with respect to GILTI category income only after all other foreign source income has been considered. These changes to the foreign tax credit limitation regime would be effective for tax years beginning after December 31, 2022.

In addition, the bill would amend Section 6511(d)(3)(A) to apply the special period during which a taxpayer may claim a credit or refund attributable to foreign taxes only where the credit or refund is attributable to a change in foreign tax liability, and would clarify that, in the case of indirect foreign tax credits, the period begins from the date prescribed by law for filing a return for the tax year in which the taxes are paid (or deemed paid under Section 960). The bill also would amend Section 901 to determine the period during which to allow taxpayers to choose to claim a credit for foreign taxes for a tax year by reference to Section 6511(d)(3), but would provide taxpayers only the general three-year period of limitations provided in Section 6511(a), or a longer period under Section 6511(c) if extended by agreement, to change from a credit to a deduction for foreign taxes.

The bill also would require (except as otherwise provided by Treasury) foreign tax redeterminations to be taken into account under Section 905(c) for the tax year the taxes are paid, rather than in the tax year to which the taxes relate as under current law. These changes generally would become effective 60 days after enactment.

The bill eliminates Section 904(b)(4), which currently excludes from the foreign tax credit limitation calculation section 245A dividends and deductions allocable to such dividends or to the stock associated with such dividends. Instead the bill includes an amendment to Section 864(e) to add Section 245A, which would have the effect of treating, for purposes of expense allocation and apportionment, Section 245A eligible dividends as exempt income and the associated stock on which such dividends were paid as exempt assets.

The principles of Section 338(h)(16) would apply in determining the source and character of any item with respect to a ‘covered asset disposition’ – generally, a transaction treated as a disposition of assets for US tax purposes and as a disposition of corporate stock (or disregarded) for foreign tax law purposes. These changes would be effective for transactions after the date of enactment.

The bill further directs Treasury to provide in regulations for the application of per country separate limitations to foreign tax credit carryforwards from tax years in which the per-country separate limitations did not apply to a tax year in which such per country limitation does apply.

**Observation:** While the per-country application of GILTI will have a negative effect on taxpayers, the limited allocation of deductions to the GILTI basket, as well as the special separate limitation loss rules applicable to the GILTI basket, are taxpayer-favorable changes, which should help to preserve GILTI-basket foreign tax credit limitation. Further, the amendment to Section 904(c) to permit the carryforward of excess foreign taxes (i.e., the foreign tax credit carryforward) in the GILTI basket is welcomed. Nevertheless, it is likely that the OECD’s Pillar Two proposals will provide more meaningful relief with respect to ensuring that timing differences and variations in effective tax rates over time do not result in double taxation of foreign income.
Modifications of foreign tax credit rules applicable to dual capacity taxpayers

Under the bill, ‘dual capacity taxpayers’ (i.e., US persons that are subject to a foreign levy and also receive certain benefits from the foreign country or US possession) would be denied Section 901 credits in excess of the generally applicable income tax (i.e., an income tax, or a series of income taxes, generally imposed on residents that are not dual capacity taxpayers) under the laws of a foreign country or US possession. This provision would be effective for amounts paid or accrued after December 31, 2021.

Observation: This provision is expected to deny a claim of foreign tax credits by dual capacity taxpayers that pay amounts to a foreign country when the foreign country does not have a generally applicable income tax that is imposed on residents of the country, and would otherwise limit the amount of any potential credit to the amount that otherwise would be imposed on the dual capacity taxpayer under any relevant generally applicable income tax.

Observation: This change could have a significant impact on companies in the natural resource industry that presently utilize the facts and circumstances method.

Foreign oil-related income to include oil shale and tar sands

The bill retains without modification a Way and Means provision that would expand the definition of foreign oil-related income in Section 907(c)(2)(A) to include oil shale and tar sands, effective for tax years of foreign corporations beginning after December 31, 2021.

Modification to deemed paid credit for taxes properly attributable to tested income

The bill would amend Section 904(d)(1) to effectively reduce the ‘haircut’ on deemed paid credits for taxes attributable to GILTI under Section 960(d) from 20% to 5% and amend Section 960(d)(3) potentially to allow foreign taxes incurred by net tested loss CFCs to be credited. In addition, for the first time, the bill would impose a consistent 5% haircut on taxes deemed paid in connection with the distribution of previously taxed E&P related to GILTI.

These changes would be effective for tax years of foreign corporations beginning after December 31, 2022.

Observation: While the Biden administration proposal retained a current-law foreign tax credit ‘haircut,’ the bill would reduce the haircut, resulting in US tax being assessed on GILTI at rates up to approximately 15.8%.

Repeal of election for one-month deferral in determining tax year of specified foreign corporations

The bill repeals Section 898(c)(2), which allows a specified foreign corporation (as defined in Section 898(b)) to elect a tax year beginning one month earlier than the majority US shareholder year (as defined in Section 898(c)(3)). This change would be effective for tax years of specified foreign corporations beginning after November 30, 2022.

Observation: The repeal of Section 898(c)(2) is expected to result in a specified foreign corporation generally being required to adopt the majority US shareholder year. This also means that the conforming short year for calendar-year taxpayers would be December 1, 2022 to December 31, 2022. Unlike the Ways and Means provision, the bill directs Treasury to prescribe regulations to allocate foreign taxes that accrue during this short year between the short year and the prior year.
Deduction for foreign source portion of dividends limited to CFCs

The bill would amend Section 245A to limit availability of the Section 245A dividends received deduction to dividends from CFCs (dividends from specified 10%-owned foreign corporations no longer would be eligible). This change would apply to distributions made after the enactment of the bill.

In addition, the bill would amend the language in Section 245A(g), which authorizes regulations or other guidance as may be necessary or appropriate to carry out the provisions of Section 245A, including where a US shareholder owns stock of a specified 10%-owned foreign corporation through a partnership. This language would be amended by (1) changing the reference to a ‘specified 10% owned foreign corporation’ to ‘CFC’ in accordance with other changes in the bill, and (2) adding a second section to include the denial of all or a portion of the Section 245A dividends received deduction for dividends arising from certain related-party transactions during the post-2017 ‘gap period’ for fiscal-year taxpayers. The regulations authorized under amended Section 245A(g) would apply to distributions made after the enactment of the bill.

Observation: Limiting the Section 245A dividends received deduction to dividends from CFCs may be mitigated in some fact patterns through a new election regime in the bill to treat certain foreign corporations as CFCs, as discussed below. However, where taxpayers are unable to make this election (e.g., because they are unable to obtain the necessary information from the relevant foreign corporation in which they own a minority interest), the result would be double taxation of foreign earnings of 10%-owned subsidiaries for the first time in over 70 years.

Modifications related to determination of status as a CFC

The bill retains without substantive modification a Ways and Means provision that would restore former Section 958(b)(4), providing that a US person is not treated as owning stock that is directly owned by a non-US person when applying the downward attribution rules. The bill also would add new Section 951B, which generally would apply the subpart F provisions to any ‘foreign controlled United States shareholder’ (i.e., a US majority shareholder without regard to the application of restored Section 958(b)(4)) of a ‘foreign CFC’ (i.e., a foreign corporation, other than a CFC, that would qualify as a CFC if ‘foreign controlled United States shareholder’ is substituted for ‘United States shareholder’ and ownership is determined without regard to Section 958(b)(4)). The bill also would allow certain foreign corporations with US shareholders to elect to be treated as CFCs. These changes would be effective for tax years of foreign corporations beginning after the date of enactment.

Observation: The provision to restore former Section 958(b)(4), along with the introduction of Section 951B that is more narrowly targeted to address decontrolled structures, generally is expected to address certain unintended consequences that arose from the repeal of Section 958(b)(4) under the 2017 tax reform legislation.

Limitation on foreign base company sales and services income

The bill would amend Section 954(d)(2) to limit the definition of a related person for purposes of the foreign base company sales income (FBCSI) and foreign base company services income (FBCSvI) rules to a taxable unit (within the meaning of Section 904(e)), which is a tax resident of (or, in the case of a branch, located in) the United States. This amendment would apply for tax years of foreign corporations beginning after December 31, 2021.

Observation: Section 954(d)(2) currently provides the statutory branch rule for foreign base company sales income (FBCSI), pursuant to which branches of a CFC may be treated as separate corporations for purposes of applying the FBCSI rules. This amendment would replace the statutory branch rule with a rule limiting related-person transactions for FBCSI and FBCSvI purposes to transactions with taxable units that are US tax residents. Note, however, that the amendment also would grant regulatory authority to provide guidance addressing the application of this rule to a series of transactions in which a related person is a party, and to situations in which the legal status
or any activity of a pass-through entity or branch held by a CFC and located outside of the CFC’s country of organization would be treated as a wholly owned subsidiary corporation. Accordingly, future regulations may require consideration of parties beyond those directly participating in a transaction to determine whether a series of transactions or a branch structure may give rise to FBCSI or FBCSvI.

**Subpart F pro rata determination**

The bill would amend Section 951(a), which sets forth the pro rata share rules for subpart F purposes. Under the provision, a US shareholder’s pro rata share of subpart F income would be determined based on whether it owns, within the meaning of Section 958(a), stock of a foreign corporation as of the close of the last day of the tax year in which the foreign corporation is a CFC (the last relevant day). If the shareholder has Section 958(a) ownership of the CFC’s stock on the last relevant day, the pro rata share would be the shareholder’s ‘general pro rata share’ determined under new Section 951(a)(3). If the shareholder does not have such ownership, the pro rata share would be the ‘aggregate non taxed current dividend shares’ as determined under new Section 951(a)(4). These rules would apply to tax years of foreign corporations beginning after December 31, 2021.

**Observation:** One potential consequence of the proposed changes to Section 951(a) appears to be the inclusion of subpart F or GILTI amounts in a US shareholder’s income where the shareholder has disposed of its CFC shares prior to the end of the CFC’s tax year and a dividend paid with respect to the shares is excluded from the US shareholder’s income pursuant to Section 245A(a) or from the CFC’s income pursuant to the high-tax exception in Section 954(b)(4), the same-country exception in Section 954(c)(3), or the look-through rule in Section 954(c)(6). In addition, under the provision acquirers of foreign targets may be required to take into account subpart F and GILTI inclusions greater than the target’s post-acquisition earnings if a pre-acquisition distribution was made to a foreign seller.

**Modifications to BEAT**

The bill would amend the BEAT rate to 10% for tax years beginning after December 31, 2021, and before January 1, 2023; 12.5% for tax years beginning after December 31, 2022, and before January 1, 2024; 15% for tax years beginning after December 31, 2023, and before January 1, 2025; and 18% for tax years beginning after December 31, 2024. Further, the increased rate for banks and securities dealers under the current rule would not apply to any tax year beginning after December 31, 2024.

Under the provision, the base erosion minimum tax amount would be determined without regard to any credits (i.e., regular tax liability would be larger, resulting in a smaller base erosion minimum tax amount), and Section 38 general business credits may be taken against the BEAT.

The bill would eliminate the 3% base erosion percentage threshold except for tax years beginning before January 1, 2024. For tax years beginning before January 1, 2024, the base erosion percentage would be computed by reference to Section 59A(c)(4) as in effect before its removal under the bill. Such computation of the temporarily applicable base erosion percentage is expected to take into account the definition of a base erosion tax benefit (and other attributes affecting the computation of base erosion percentage) as revised under the bill as of the effective date of the provision (December 31, 2021).

The bill would amend Section 59A(c) to compute modified taxable income by (1) disregarding base erosion tax benefits, (2) disregarding any base erosion payments in determining the basis of inventory property, (3) determining NOLs without regard to any deduction that is a base erosion tax benefit, and (4) making adjustments under rules similar to the rules applicable to the alternative minimum tax (e.g., the tax benefit rule under Section 59(g), limitations on a partner’s distributive share of partnership loss under Section 704(d), and the at-risk loss limitation under Section 465).
As mentioned above, for determining modified taxable income, the basis of inventory would be computed without regard to base erosion payments. In this regard, the bill would expand the definition of a base erosion payment by including certain inventory-related amounts paid or accrued to a foreign related party, such as payments for indirect costs that are capitalized under Section 263A and payments for inventory that exceed direct and certain indirect costs of the inventory in the hands of the foreign related party. The bill would provide a safe harbor for indirect costs of inventory in the hands of a foreign related party equal to 20% of the amount paid or accrued by the taxpayer to the foreign related party in connection with the acquisition of such property.

**Observation:** While these changes would expand the definition of base erosion payment to include some payments that are included in cost of goods sold (COGS), the bill does not treat all COGS as base erosion payments.

**Observation.** Although provisions of the bill would make the BEAT harsher on those taxpayers to whom it continues to apply, payments to CFCs of US-based multinational groups generally no longer would be subject to the BEAT. A new exception from the definition of base erosion payment is provided for payments subject to tax as GILTI, Subpart F income, or ECI. A similar exception is provided for payments to foreign affiliates that are subject to an effective foreign tax rate of at least 15% (or the applicable BEAT rate, if lesser) as determined to the satisfaction of Treasury. It is anticipated that this second exception will be implemented by regulations that call off the BEAT for payments to affiliates of foreign-based MNEs that are subject to an OECD Pillar Two qualified income inclusion rule. If Pillar Two is implemented on a broad basis, the BEAT would be significant only for those MNEs that are headquartered in jurisdictions that do not implement Pillar Two, and, even in those circumstances, the impact of the BEAT would largely be limited to payments made to affiliates of the MNE that are subject to a low rate of foreign tax.

The bill would expand the existing withholding tax exception for base erosion payments by generally exempting amounts (determined under rules similar to the rules of the pre-2017 tax reform Section 163(j)(5)) on which US federal income tax is imposed. In line with the Biden Administration’s SHIELD proposal, the bill exempts payments subject to an effective foreign tax rate not less than the lesser of 15% or the applicable BEAT rate for that tax year. The bill would, to the extent provided under regulations, treat a payment made to a foreign related party as made to a second foreign related party to the extent such payment directly or indirectly funds a payment to the second foreign related party if the second foreign related party does not satisfy the aforementioned foreign effective tax rate threshold (the “funding rule”). The bill authorizes Treasury to issue guidance providing procedures for determining the foreign effective tax rate, including rules that may recharacterize the parties to a transaction or series of transactions.

The bill would impose continuing applicable taxpayer status on any taxpayer who is an applicable taxpayer for any tax year beginning after December 31, 2021. Such taxpayer (and its successor) would carry the applicable taxpayer status for the 10 succeeding tax years.

Amended Section 59A is proposed to apply to tax years beginning after December 31, 2021.

**Observation:** The elimination of the base erosion percentage threshold post-2024 may be mitigated by the new exceptions on amounts subject to US tax or a sufficient effective foreign tax rate. The bill also would modify the BEAT base by treating certain costs included in inventory as base erosion payments while retaining an exception for amounts that relate to services that meet the requirements for eligibility for the services cost method. On the other hand, the modification to the treatment of credits for determining the base erosion minimum tax amount is taxpayer-favorable, and an additional benefit would be provided by allowing Section 38 credits against the tax under BEAT.
**Observation:** The provision also seeks to alleviate the overinclusive application of BEAT by exempting from base erosion payments amounts that already are subject to US tax or subject to sufficient foreign tax. The funding rule, however, which would require implementing regulations, may entail significant complexity (as exhibited by the funding rule for imported mismatch payment under the Section 267A regulations) in determining what constitutes a direct or indirect “funding.” Taxpayers may have to create visibility and monitor payment flows in the broader global group to evaluate base erosion payment exposure resulting from the application of the funding rule.

The 10-year continuing applicable taxpayer status provision is potentially significant. It would subject any taxpayer who is an applicable taxpayer for any tax year after December 31, 2021, to BEAT for 10 years, regardless of any decrease in gross receipts. This also means that a taxpayer that is below the base erosion percentage threshold for one of the tax years before 2024 would not be able to avail itself of the exemption even though the base erosion percentage test is still in effect pre-2024.

**Observation:** Taken together, the changes to the BEAT described above could significantly reduce the circumstances in which US-headquartered companies would be subject to the BEAT. Specifically, the exemption from base erosion payments for amounts that are subject to US tax (including effectively connected income, as well as amounts subject to tax under subpart F or GILTI) likely could result in US multinationals not having any significant base erosion payments.

**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 modify the definition of ‘10-percent shareholder’ with respect to corporations under Section 871(h)(3)(B)(i) to include ownership by value. This provision would apply to obligations issued after the date of enactment.

**Adjustments to earnings and profits of CFCs**

The bill would allow the E&P of a CFC to be determined using a LIFO inventory method, the installment sale method, or the completed contract method. This amendment would be effective for tax years of foreign corporations ending after the date of the enactment and tax years of US shareholders in which or with which such tax years of foreign corporations end.

**Observation:** This amendment could have an impact on the determination of E&P of a CFC electing one or more of these methods for broader purposes of the Code.

**Certain dividends from CFCs to US shareholders treated as extraordinary dividends**

The bill would add new Section 1059(g), providing that any disqualified CFC dividend is treated as an extraordinary dividend without regard to the period the taxpayer held the stock to which such dividend relates (i.e., the general two-year holding period requirement under Section 1059). For purposes of this new rule, a disqualified CFC dividend means any dividend paid by a CFC if such dividend is attributable to earnings and profits that were earned while such foreign corporation was not a CFC or are attributable to disqualified CFC dividends received by a CFC from another CFC. A foreign corporation treated as a CFC as a result of the repeal of Section 958(b)(4) is not treated as a CFC for purposes of applying Section 1059(g). This provision would apply to dividends paid (or amounts treated as dividends) after the date of enactment.

**Clarification of treatment of DISC gains and distributions of certain foreign shareholders**

The bill retains without modification a Ways and Means provision that would modify Section 996(g) to provide that gains from the sale or exchange of, and distributions by, a DISC or FSC to a foreign shareholder are treated as effectively connected with the conduct of a trade or business conducted through a permanent establishment that is
'deemed to be had by' the shareholder in the United States. This amendment would be effective for gains and distributions after December 31, 2021.

**Extension of expensing of research and experimental costs under Section 174**

The bill retains without modification a Ways and Means provision that would extend the expensing of research and experimental costs under Section 174 for expenses paid or incurred in tax years beginning before 2026. Section 174 expensing currently is scheduled to expire for tax years beginning after 2021.

**Observation:** Taxpayers with research and experimental expenses would continue to have the options of deducting in the tax year paid or incurred, capitalizing and amortizing generally over five years under Section 174, capitalizing under Section 263(a) and amortizing over the useful life under Section 167, or capitalizing and amortizing over 10 years under Section 59(e).

**Observation:** Unlike tax increase provisions in the bill, this provision is expected to have support from both Democrats and Republicans since research activities are seen as having broad economic benefits. Bipartisan legislation has been introduced in both the House and Senate to delay or repeal the scheduled move to capitalize and amortize research and experimental costs.

**Modifications to treatment of losses in certain controlled group corporation liquidations**

The bill would add new Section 267(h), which would defer the recognition of certain losses realized on the stock or securities of a liquidating corporation in the case of any "specified controlled group liquidation." Specifically, no loss would be recognized on the stock or securities of a liquidating corporation in a 'specified controlled group liquidation' until all members of the controlled group receiving property in such liquidation have transferred such property to one or more persons who are not related (within the meaning of Section 267(b)(3) or Section 707(b)(1)) to the member that received such property.

A 'specified controlled group liquidation' means, with respect to any corporation which is a member of a controlled group (presumably under the definition in current Section 267(f)(1)), one of more distributions in complete liquidation (within the meaning of Section 346) of such corporation or any other transfer (including any series of transfers) of property of such corporation if any stock or security of such corporation becomes worthless in connection with such transfer. The provision would apply to liquidations occurring on or after the date such provision is enacted.

**Observation:** The House Ways and Means Committee bill more narrowly applied this loss deferral rule to complete liquidations to which Section 331 applies. The provision in that bill would have effectively eliminated stock loss recognition in many so-called Granite Trust transactions, in which a corporation chooses to liquidate a subsidiary in a taxable liquidation under Section 331 -- instead of a tax-free liquidation under Section 332 -- by transferring a portion of the subsidiary's stock before the liquidation. In addition to impacting Granite Trust transactions, the bill would expand the scope of this provision to also defer certain worthless stock deductions under Section 165(g) involving liquidations.

Other amendments in the bill acknowledge that abandonment can serve as an identifiable event for purposes of securing a worthless stock deduction under section 165(g). Those amendments could serve to highlight abandonment as an alternative to liquidation in claiming a worthless stock deduction, particularly where the corporation in question may not have assets remaining to sell to an unrelated party following a liquidation.
Additional limitation on divisive reorganizations in the context of leveraged spinoffs

The bill would add new Section 361(d), which would limit the tax-free transfer of nonqualified preferred stock and debt securities of the controlled corporation by a distributing corporation to its creditors. Under new Section 361(d), a distributing corporation in a divisive reorganization would recognize gain on the distribution of nonqualified preferred stock and debt securities of the controlled corporation to the extent that the fair market value of such nonqualified preferred stock and the principal amount of such securities exceeds the excess of (1) the basis of the assets transferred by the distributing corporation to the controlled corporation in the reorganization, over (2) the liabilities assumed by the controlled corporation in such transaction.

Although the provision generally would apply to reorganizations occurring on or after the date enacted, a special transition rule would except exchanges occurring pursuant to a transaction that is (1) made pursuant to a written agreement that was binding on the date the bill is enacted and at all times thereafter, (2) described in a ruling request submitted to the IRS on or before such date, or (3) described on or before such date in a public announcement or in a filing with the Securities and Exchange Commission.

Observation: Under current law, nonqualified preferred stock and newly issued debt securities of the controlled corporation may be received and distributed by a distributing corporation in a divisive reorganization without the recognition of gain. Although the bill language is not entirely clear, it seems that new Section 361(d) would limit the amount of nonqualified preferred stock and newly issued debt securities of the controlled corporation that may be distributed by a distributing corporation to its creditors without the recognition of gain.

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 Code or the regulations. The proposed definition is the same as in the infrastructure bill passed by the Senate on August 10, 2021. The proposed statutory text provides fairly broad discretion to Treasury 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.

Expansion of wash sale rules

The bill would expand the types of assets subject to the wash sale rules to include, for example, 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 bill, and would expand the scope of the current law with respect to short positions and swaps (i.e., “notional principal contracts”).

Observation: The lack of a business-needs exception for digital assets could prove problematic for businesses that receive digital assets (like cryptocurrency) as payment for goods and services or otherwise transact in these assets as part of the normal course of their trades or businesses.

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 basis adjustment to the extent a related party (other than the taxpayer’s spouse) acquires substantially identical assets.

The provision is 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. These amended basis adjustment rules, however, generally prevent a loss that is disallowed under the wash sale rules because of a related-party acquisition from being added to the basis of substantially identical assets acquired by such related party (unless the related party is the taxpayer’s spouse), which may result in a permanent disallowance (rather than a deferral) of such loss.

Dividend equivalent amounts on derivatives referencing partnerships

The bill would amend Section 871(m) to provide that payments pursuant to specified notional principal contracts with respect to publicly traded partnerships (PTPs) and other partnerships (as provided in regulations) are treated as dividend equivalents. The bill provision in substance generally is consistent with the House Ways and Means provision, with various clarifying changes.

The bill clarifies that income or gain for purposes of calculating dividend equivalents includes any income or gain from the deemed disposition of the partnership interest (using Section 864(c)(8) principles) as a result of the termination of the contract.

Treasury is 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 or securities lending transactions.

The amendments made by this provision apply to payments made after December 31, 2022.
Observation: In addition, if enacted, these new rules would be effective for existing swaps on payments made beginning in 2023.

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.

For estates and trusts, the new 5% surcharge applies to adjusted gross income in excess of $200,000, with an additional 3% surcharge applying to adjusted gross income in excess of $500,000. As provided under Section 67(e), the adjusted gross income of an estate or trust 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 apply to tax years beginning after December 31, 2021.

Observation: Wholly charitable trusts are excluded. Additional guidance on how the surcharge would apply to particular types of trusts may be required. 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 the legislation. Also, as charitable deductions are not specified as a deduction that is allowed in determining the estate or trust’s adjusted gross income, the surcharge would appear to apply to income even if the trust contributed all of that income to a charity. This would affect any nongrantor trust making a charitable contribution but could particularly affect nongrantor charitable lead trusts.

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 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. The provision indicates that the NIIT would not be assessed on income on which FICA already is imposed.

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.

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

Observation: In light of the potential rate increases, if there continues to be any limitation on the deductibility of state and local taxes for individuals, any available deductions to offset federal taxable income increase in value. Taxpayers may want to consider the cost/benefit of using pass-through entities and the available elective entity-level state tax regimes to address the impact of the SALT cap.

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 in 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.

Observation: This proposal 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.

Exclusion of gain from the sale of Qualified Small Business Stock limited

As Section 1202 was originally enacted in 1993, 50% of the gain from the sale or exchange of qualified small business stock held for more than five years was excluded from the gross income of any taxpayer other than a corporation, subject to certain limitations. An amount equal to 7% of the amount excluded from gross income under Section 1202 was treated as a tax preference item for purposes of calculating a taxpayer’s alternative minimum tax. Section 1202 was amended to increase the gain exclusion to 75% for all qualified business stock acquired after February 17, 2009. The provision was amended further to increase the gain exclusion to 100% and to eliminate the AMT preference item for all qualified small business stock acquired after September 27, 2010.

The bill would provide that the 75% and 100% exclusion rates and the elimination of the AMT preference item would not apply to taxpayers with adjusted gross income equal or exceeding $400,000, as well as for any trust or estate. The provision would apply to all sales or exchanges of qualified small business stock after September 13, 2021, subject to a binding contract exception.

Observation: Following the expansion of the Section 1202 gain exclusion to 100%, individual investors have given more consideration to this incentive to invest in small businesses. With this limitation on potential benefits for certain high-income taxpayers and for trusts, it remains to be seen what impact the provision would have on future investment in small businesses.
Expansion of deduction limit on compensation paid to executive officers of public companies

Section 162(m) currently imposes a $1 million deduction limit on compensation paid to certain executive officers of publicly held corporations, including the CEO, CFO, and three highest-paid executive officers. A publicly held corporation currently is defined in terms of the public company and its corporate affiliates and also has a special rule for up-C structures.

The bill would change the aggregation rules to a parent-subsidiary controlled group; this would capture compensation paid to covered employees by entities below a partnership that currently breaks the chain of affiliated corporations. The provision also would expand the reach of the deduction limit to payments made through a pass-through or other entity. It also would clarify that the deduction limit applies to performance-based compensation, commissions, and payments after the covered employee terminates. These provisions would go into effect for tax years beginning after December 31, 2021.

Observation: The bill appears to address strategies to limit the impact of Section 162(m) by paying compensation to covered employees at entities that are not in the public company’s affiliated group and to address payment of compensation through a management services agreement. The bill does not include a Ways and Means Committee provision that would have accelerated the addition of the five highest-paid employees to the list of covered employees, effective for tax years beginning after December 31, 2021. This current-law rule remains scheduled to go into effect for tax years beginning after December 31, 2026.

Backup withholding for third-party network payments

The American Rescue Plan Act of 2021 (the APRA) significantly modifies the reporting threshold associated with Form 1099-K, Payment Card and Third Party Network Transactions, from $20,000 in aggregate payments and 200 transactions to solely a threshold of $600 in aggregate payments (with no minimum transaction requirement), effective beginning with payment transactions settled after December 31, 2021.

The bill would amend Section 3406 to provide a transition year to implement the lower reporting threshold to reduce the impact on the requirement to impose backup withholding. A third-party settlement organization (TPSO) generally would be subject to backup withholding on payments made in settlement of third-party network transactions only if (1) the aggregate annual amount of such payments to the payee equals or exceeds $600 or (2) the third-party settlement organization was required under Section 6050W to file an information return for the preceding year with respect to the payee. The bill includes a backup withholding transition rule for calendar year 2022 that would require that the aggregate number of annual transactions settled by the third-party settlement organization for a participating payee exceed 200 before the requirement to impose backup withholding applies to a payee that failed to provide its taxpayer identification number (TIN).

Observations: The transition year is a welcome relief. Many organizations responsible for reporting on Forms 1099-K indicate that the lower reporting threshold will increase 2022 reporting obligations 10 to 20 fold. Time is needed to obtain TINs from existing customers that were casual users of TPSOs and consequently were not previously required to provide their TIN for purposes of Form 1099 reporting. Filing organizations should begin the process of obtaining TINs for existing users that will likely exceed the $600 reporting threshold.

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.

**Observation:** The proposed increases in funding would allow the IRS to increase the size of its workforce, greatly expanding its ability to conduct examinations of large corporations and high-net worth individuals.

**Tax accounting implications**

The income tax financial accounting standard requires that the effects of a change in tax law or rates be recognized in the period that includes the enactment date. For US federal tax purposes, the enactment date is most often the date the President signs the bill into law. From a state and local income tax perspective, companies would need to analyze how each jurisdiction adopts or otherwise conforms to the Internal Revenue Code (e.g., adoption of the Code as of a specific date, 'rolling conformity' that adopts federal amendments automatically, or other approaches).

The total effect of changes in tax laws or rates on current and deferred tax balances are recorded as a component of the income tax provision related to continuing operations for the period in which the law is enacted, even if the assets and liabilities relate to other components of the financial statements, such as discontinued operations, a prior business combination, or items of accumulated other comprehensive income. These impacts may include, but are not limited to, changes to assessments surrounding the realizability of existing deferred tax assets (e.g., foreign tax credit or interest limitation carryovers). Importantly, companies should further consider which elements of the existing draft legislation relate to taxes based upon income (and thus included within the scope of the ASC 740 income tax accounting model), as opposed to non-income based taxes (which would be accounted for outside of the income tax accounting model, e.g., excise taxes).

To the extent that an enactment date occurs within an interim accounting period, companies would need to determine what impacts of the federal amendments are recognized through the annual effective tax rate and what should be recorded discretely in the period of the enacted change in tax law.

**Summary of effective dates**

<table>
<thead>
<tr>
<th>Provision</th>
<th>Effective Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate profits minimum tax</td>
<td>Tax years beginning after December 31, 2022</td>
</tr>
<tr>
<td>Surtax on corporate stock repurchases</td>
<td>Repurchases after December 31, 2021</td>
</tr>
<tr>
<td>Interest expense of international financial reporting groups - Section 163(n)</td>
<td>Tax years beginning after December 31, 2022</td>
</tr>
<tr>
<td>Modifications to deduction for FDII &amp; GILTI</td>
<td>Reduction of the Section 250 deduction</td>
</tr>
<tr>
<td></td>
<td>Tax years beginning after December 31, 2022</td>
</tr>
<tr>
<td>Provision</td>
<td>Effective Date</td>
</tr>
<tr>
<td>--------------------------------------------------------------------------</td>
<td>--------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Changes to Section 250(b)</td>
<td>Tax years beginning after the date of the enactment</td>
</tr>
<tr>
<td>Modifications to inclusion of GILTI (e.g., country by country, tested loss carryover, 5% of QBAI, etc.)</td>
<td>Tax years of foreign corporations beginning after December 31, 2022</td>
</tr>
<tr>
<td>Modifications to foreign tax credit limitation and related provisions</td>
<td>Modification of FTC carryback and carryforward</td>
</tr>
<tr>
<td></td>
<td>Tax years beginning after December 31, 2022</td>
</tr>
<tr>
<td></td>
<td>Certain asset disposition (Section 338(h)(16) principles)</td>
</tr>
<tr>
<td></td>
<td>Transactions after the date of the enactment</td>
</tr>
<tr>
<td></td>
<td>Redetermination of FTC and related claims</td>
</tr>
<tr>
<td></td>
<td>60 days after the date of enactment (with an exception)</td>
</tr>
<tr>
<td></td>
<td>Others</td>
</tr>
<tr>
<td></td>
<td>Tax years beginning after December 31, 2022</td>
</tr>
<tr>
<td>Modifications of foreign tax credit rules applicable to dual capacity taxpayers</td>
<td>Amounts paid or accrued after December 31, 2021</td>
</tr>
<tr>
<td>Foreign oil-related income to include oil shale and tar sands</td>
<td>Tax years of foreign corporations beginning after December 31, 2021</td>
</tr>
<tr>
<td>Modification to deemed paid credit for taxes properly attributable to tested income</td>
<td>In general</td>
</tr>
<tr>
<td></td>
<td>Tax years of foreign corporations beginning after December 31, 2022</td>
</tr>
<tr>
<td>Provision</td>
<td>Effective Date</td>
</tr>
<tr>
<td>--------------------------------------------------------------------------</td>
<td>--------------------------------------------------------------------------------</td>
</tr>
<tr>
<td><strong>Haircut to taxes on GILTI PTEP distributions</strong></td>
<td>Tax years of foreign corporations beginning after date of enactment</td>
</tr>
<tr>
<td><strong>Repeal of election for one-month deferral in determining tax year of specified foreign corporations - Section 898(c)</strong></td>
<td>Tax years of specified foreign corporations beginning after November 30, 2022</td>
</tr>
<tr>
<td><strong>Deduction for foreign source portion of dividends limited to CFCs - Section 245A</strong></td>
<td>Distributions made after the date of enactment</td>
</tr>
<tr>
<td><strong>Modifications related to determination of status as a CFC - Sections 958(b)(4) and 951B</strong></td>
<td>Tax years of foreign corporations beginning after the date of enactment</td>
</tr>
<tr>
<td><strong>Limitation on foreign base company sales and services income</strong></td>
<td>Tax years of foreign corporations beginning after December 31, 2021</td>
</tr>
<tr>
<td><strong>Subpart F pro rata determination</strong></td>
<td>Tax years of foreign corporations beginning after December 31, 2021</td>
</tr>
<tr>
<td><strong>Modifications to BEAT</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>Rate changes</strong></td>
</tr>
<tr>
<td></td>
<td>Tax years beginning after December 31, 2021</td>
</tr>
<tr>
<td></td>
<td><strong>New scope/mechanics</strong></td>
</tr>
<tr>
<td></td>
<td>Tax years beginning after December 31, 2021</td>
</tr>
<tr>
<td></td>
<td><strong>3% threshold</strong></td>
</tr>
<tr>
<td></td>
<td>Tax years beginning before January 1, 2024 (and eliminated thereafter)</td>
</tr>
<tr>
<td>Provision</td>
<td>Effective Date</td>
</tr>
<tr>
<td>--------------------------------------------------------------------------</td>
<td>--------------------------------------------------------------------------------</td>
</tr>
<tr>
<td><strong>Modification to the portfolio interest exemption - Section 871(h)</strong></td>
<td>Obligations issued after the date of enactment</td>
</tr>
<tr>
<td><strong>Adjustments to earnings and profits of CFCs - Section 312(n)</strong></td>
<td>Tax years of foreign corporations ending after the date of enactment</td>
</tr>
<tr>
<td><strong>Certain dividends from CFCs to US shareholders treated as extraordinary dividends - Section 1059(g)</strong></td>
<td>Dividends paid (or amounts treated as dividends) after the date of enactment</td>
</tr>
<tr>
<td><strong>Clarification of treatment of DISC gains and distributions of certain foreign shareholders - Section 996(g)</strong></td>
<td>Gains and distributions after December 31, 2021</td>
</tr>
<tr>
<td><strong>Extension of expensing of research and experimental costs under Section 174</strong></td>
<td>Expenses paid or incurred in tax years beginning before 2026</td>
</tr>
<tr>
<td><strong>Modifications to treatment of certain losses - Section 165(g) and Section 331</strong></td>
<td><strong>Worthless capital assets</strong>&lt;br&gt;Losses arising in tax years beginning after December 31, 2021</td>
</tr>
<tr>
<td><strong>Controlled group liquidations</strong></td>
<td>Liquidations on or after the date of enactment</td>
</tr>
<tr>
<td><strong>Additional limitation on divisive reorganizations in the context of leveraged spinoffs - Section 361(d)</strong></td>
<td>Reorganizations occurring on or after the date of enactment, except for certain reorganizations described in a transition rule</td>
</tr>
<tr>
<td><strong>Expansion of constructive sales rules to digital assets</strong></td>
<td>Constructive sales that occur, or for contracts entered into, after the date of enactment</td>
</tr>
<tr>
<td><strong>Expansion of wash sale rules to new asset classes (including commodities, foreign currencies, and digital assets) and related-party acquisitions</strong></td>
<td>Sales, dispositions, and terminations after December 31, 2021</td>
</tr>
<tr>
<td>Provision</td>
<td>Effective Date</td>
</tr>
<tr>
<td>-----------</td>
<td>----------------</td>
</tr>
<tr>
<td>Dividend equivalent amounts on derivatives referencing partnerships</td>
<td>Payments made after December 31, 2022</td>
</tr>
<tr>
<td>New 5% and additional 3% individual surcharges imposed</td>
<td>Tax years beginning after December 31, 2021</td>
</tr>
<tr>
<td>Scope of Net Investment Income Tax (NIIT) expanded</td>
<td>Tax years beginning after December 31, 2021</td>
</tr>
<tr>
<td>Excess Business Loss Deduction for noncorporate taxpayers limited</td>
<td>Tax years beginning after December 31, 2020</td>
</tr>
<tr>
<td>Expansion of deduction limit on compensation paid to executive officers of public companies - Section 162(m)</td>
<td>Tax years beginning after December 31, 2021</td>
</tr>
<tr>
<td>Backup withholding third party network</td>
<td>Calendar years beginning after December 31, 2021</td>
</tr>
<tr>
<td>Exclusion of gain from the sale of Qualified Small Business Stock limited</td>
<td>Sales or exchanges of qualified small business stock after September 13, 2021, subject to a binding contract exception</td>
</tr>
</tbody>
</table>

For more information

- Revised Build Back Better full bill [text](#) / text of revenue-raising provisions
- Revised Build Back Better bill [section-by-section](#)

Let’s talk

For a deeper discussion of how this issue might affect your business, please contact:

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</tr>
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</table>

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