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International Tax ADVISORY ▪

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The Other Green Book: Treasury Explains Administration's Tax Proposals

Following the Georgia Senate election upset that gave Democrats control of both the House and Senate, our January International Tax advisory focused on the suddenly realistic international tax proposals of the Biden-Harris campaign. The details of those proposals have been trickling out in the months since, and just before the long Memorial Day weekend, the Treasury released the "Green Book," adding more color to the now Biden-Harris Administration's revenue proposals.

With the proposed changes to the Code, the Administration is hoping to raise revenue, enhance tax administration, and make the tax system more equitable. A number of the proposals would significantly modify, if not scuttle, provisions added by the 2017 Tax Cuts and Jobs Act (TCJA). The fate of the Biden-Harris Administration's specific tax plans remains subject to daunting procedural realities, including slim Democratic majorities in Congress, and translation to actual legislative text (which could vary substantially). Still, it seems likely that taxpayers will see at least some changes to the tax laws in the near future, including a stronger IRS.

Tax Rates

Tax rate proposals include raising the corporate income tax rate from 21% to 28% and the top individual income tax rate from 37% back to the pre-TCJA rate of 39.6% and implementing a 15% minimum tax on book income of large corporations with at least $2 billion in pre-tax net income (a significant increase from the threshold from the campaign trail). The Administration also proposes repealing the preferential capital gains tax rate (currently 20%) for taxpayers earning over $1 million in income and instead taxing capital gains of such taxpayers at the proposed top ordinary rate of 39.6% (and after application of the 3.8% net investment income tax, 43.4%).

The proposal to raise the corporate income tax rate would be effective for taxable years beginning after December 31, 2021. However, for taxable years beginning after January 1, 2021 and before January 1, 2022, the tax rate would be equal to 21% plus the product of 7% multiplied by the portion of the taxable year that occurs in 2022. The proposal to implement a 15% minimum tax on book income would be effective for taxable years beginning after December 31, 2021. The proposal to tax capital gains as ordinary income to high-income taxpayers would be effective retroactively for gains recognized after the date the proposal was announced.

Global Minimum Tax Changes

A U.S. shareholder of a controlled foreign corporation (CFC) is subject to an annual global minimum tax on global intangible low-taxed income (GILTI) under Section 951A. Under current law, the calculation of the GILTI inclusion is determined by combining the U.S. shareholder's share of the tested income or loss of each of its CFCs and reducing this amount by 10% of the qualified business asset investment (QBAI) of CFCs with tested income (but not CFCs with tested losses). In computing GILTI, taxpayers can elect to exclude income of a CFC subject to an effective tax rate of at least 18.9% (i.e., 90% of the current U.S. corporate income tax rate) (the "high-tax exception"). Further, a corporate U.S. shareholder can take a 50% deduction against its GILTI inclusion, resulting in a 10.5% U.S. effective tax rate on GILTI, and claim a credit for up to 80% of deemed-paid foreign income taxes attributable to tested income. Because high-tax income and low-tax income are aggregated under current law, the foreign tax credit can effectively reduce residual U.S. tax on income subject to low foreign tax (especially if a taxpayer forgoes the high-tax exception).

The Administration's global minimum tax proposals would eliminate the reduction for QBAI and the high-tax exception (and the corresponding exception under Subpart F). The Section 250 deduction would be reduced from 50% to 25%, effectively increasing the GILITI rate for corporate U.S. shareholders from 10.5% to 21% (applying the proposed 28% corporation income tax rate). The proposal would also require a U.S. shareholder to determine its GILTI inclusion, GILTI foreign tax credit, and GILTI tax on a country-by-country basis, meaning that foreign taxes in high-tax jurisdictions could no longer offset U.S. tax on income from low-tax jurisdictions.

These global minimum tax proposals would be effective for taxable years beginning after December 31, 2021.

Restriction on Excessive Interest Deductions

The Administration proposes a new limitation on interest deduction of a member of a "financial reporting group" if the member has net interest expense for U.S. tax purposes and the member's net interest expense for financial reporting purposes (computed on a stand-alone basis) exceeds the member's share of the group's net interest expense per the consolidated financial statements ("excess financial statement net interest expense"). For this purpose, a financial reporting group means a multinational group that prepares consolidated financial statements in accordance with U.S. GAAP or International Financial Reporting Standards.

Under the proposal, a member could not deduct any "excess net interest expense," an amount equal to the member's net interest expense for U.S. tax purposes multiplied by the ratio of the member's excess financial statement net interest expense to the member's net interest expense for financial reporting purposes on a stand-alone basis. If a member's stand-alone financial reporting interest expense were less than its share of the financial reporting group's consolidated net interest expense, the member would have an excess limitation that could be carried forward. If a financial reporting group member did not substantiate its share of the group's net interest expense or if the member elected, its interest deduction could be limited to the member's interest income plus 10% of the member's adjusted taxable income as defined in Section 163(j).

Financial reporting group members subject to the proposed limitation would continue to be subject to the Section 163(j) limitation; the amount of disallowed interest expense would be determined under whichever provision produces the lower limitation. Financial services entities would not be subject to the new limitation and would be excluded from the financial reporting group in applying the proposal to other members. The proposal also would not apply to financial reporting groups reporting less than $5 million of net interest expense, in the aggregate, on one or more U.S. income tax returns for a tax year. Treasury would be authorized to issue regulations to implement the proposal, including defining interest and financial services entities, coordination with the SHIELD proposal (see below) and other interest deductibility rules, and other issues.

The proposal would be effective for taxable years beginning after December 31, 2021.

Deductions Allocable to Exempt Income

Section 265 generally disallows a deduction for an amount allocable to certain income that is wholly exempt from U.S. tax.

The Administration's proposal would expand Section 265 to disallow deductions allocable to a class of foreign gross income that is either wholly exempt from tax or taxed at a preferential rate through a deduction, such as the Section 245A deduction for certain foreign-source dividends or a GILTI inclusion for which a Section 250 deduction is allowed. The Green Book states that the proposal will include rules for determining the amount of disallowed deductions when only a partial deduction is allowed under Section 245A or 250.

This proposal would be effective for taxable years beginning after December 31, 2021.

Inversion Limitations

Section 7874 applies to certain foreign corporations that directly or indirectly acquire substantially all the assets of a U.S. corporation (a "foreign acquiring corporation"). Under current law, a foreign acquiring corporation is treated as a domestic corporation if, after the acquisition, the former shareholders of the acquired domestic corporation hold at least 80% of the ownership interests, by vote or value, of the foreign acquiring corporation by reason of their former ownership of the domestic corporation. If the percentage of the foreign acquiring corporation held by the former shareholders of the acquired domestic corporation is at least 60% but less than 80%, the foreign acquiring corporation is respected as a foreign corporation but is subject to full U.S. tax on certain income or gain of the expatriated U.S. corporation for 10 years following the inversion.

Under the Administration's proposal, a foreign acquiring corporation would be treated as a domestic corporation if the continuing shareholder ownership is at least 50%; the 60% and 80% thresholds would be eliminated. Additionally, regardless of the amount of continuing shareholder ownership, the inversion rules would apply to acquisitions where (1) the fair market value of the domestic entity is greater than the fair market value of the foreign acquiring corporation immediately before the acquisition; (2) the expanded affiliated group is primarily managed and controlled in the U.S. after the acquisition; and (3) the expanded affiliated group does not conduct substantial business activities in the country in which the foreign acquiring corporation is created or organized.

The proposal would also expand the scope of inversion rules to apply to a direct or indirect acquisition of substantially all the assets constituting a trade or business of a domestic corporation, substantially all the assets of a domestic partnership, or substantially all the U.S. trade or business assets of a foreign partnership. A distribution of stock of a foreign corporation by a domestic corporation or a partnership that represents substantially all the assets or substantially all the assets constituting a trade or business of the distributor would also be considered an acquisition subject to Section 7874.

These proposals would be effective for transactions that are completed after the date of enactment.

Repeal of BEAT and Replacement with SHIELD

The base erosion and anti-abuse tax (BEAT), added by the TCJA, applies to certain corporate taxpayers that have substantial gross receipts and make deductible payments to foreign related parties above a specified threshold.

The Administration has proposed a full repeal of the BEAT. The BEAT would be replaced by "Stopping Harmful Inversions and Ending Low-Tax Developments" (SHIELD). SHIELD would apply to a financial reporting group, which is a group of business entities that prepares consolidated financial statements and has at least one domestic corporation or partnership or a foreign entity with a U.S. trade or business, with greater than $500 million in global annual revenues.

SHIELD would disallow deductions for related-party payments and, in some cases, unrelated-party payments by reference to all gross payments made to "low-taxed members," members whose income is subject to an effective tax rate below a designated minimum tax rate. This designated minimum tax rate would be determined by reference to the OECD's Pillar Two or, if no Pillar Two rate exists at the time SHILED is enacted, 21%.

Under SHIELD, otherwise-deductible payments made by a domestic corporation or branch directly to a low-tax member would be disallowed entirely. Payments for other types of costs (such as cost of goods sold) and other deductions (including unrelated-party payments) would be disallowed up to the amount of the payment. Further, a portion of payments to non-low-tax members would be deemed made to low-tax members (and thus disallowed as deductions) based on the ratio of the group's low-tax profits to the group's total profits (per the financial reporting group's consolidated financial statements).

The SHIELD proposal would authorize Treasury to issue regulations to exempt payments by financial reporting groups that meet, on a jurisdiction-by-jurisdiction basis, a minimum effective level of tax and payments to domestic and foreign members that are investment funds, pension funds, international organizations, or nonprofit entities and to take into account payments by partnerships.

This proposal would be effective for tax years starting after December 31, 2022.

Repeal of FDII Deduction

U.S. corporations are currently entitled to deduct a percentage of their foreign-derived intangible income (FDII), which is generally a portion of a company's intangible income derived from exports. The Administration would repeal the FDII deduction and use the revenue raised to incentivize research and development in the U.S. The Green Book offers scant details but argues that the FDII deduction is not an effective way to encourage new domestic investment or R&D but rather a large tax break to companies reaping the rewards of prior innovation. The Administration also highlights that the FDII deduction is more beneficial to multinational companies with activities abroad than domestic producers because the deduction is only available to companies with high export sales.

This proposal would be effective for taxable years beginning after December 31, 2021.

Limits on Foreign Tax Credit from Sales of Hybrid Entities

A corporation that makes a qualified stock purchase can make an election under Section 338 to treat the purchase as an asset acquisition, resulting in a stepped-up basis in the corporation's assets. Section 338(h)(16) generally provides that, despite such election, for purposes of the foreign tax credit rules, any gain recognized by the seller is treated as capital gain from the sale of stock of a corporation. This prevents the seller from converting capital gain to ordinary gain, which might otherwise be offset by foreign tax credits of the taxpayer.

The Administration has proposed extending the principles of Section 338(h)(16) to the disposition of entities treated as corporations under foreign law but as partnerships or disregarded entities for U.S. tax purposes. Any gain from such disposition would be treated as capital gain from the sale of stock for purposes of the foreign tax credit rules.

This proposal would be effective for sales that occur after the date of enactment.

Tax Incentives to Encourage Onshoring and Discourage Offshoring Jobs

The Administration proposes a 10% general business credit for certain expenses related to onshoring a U.S. trade or business. "Onshoring a U.S. trade or business" means reducing or eliminating a trade or business (or line of business) currently conducted outside the United States and starting up, expanding, or otherwise moving the same trade or business to the United States—to the extent the action increases U.S. jobs. Expenses eligible for the credit would be those associated with the relocation of the trade or business but would not extend to capital expenditures or costs for severance pay and other assistance to displaced workers. The U.S. taxpayer would be able to claim the credit even if a foreign affiliate incurs the eligible expenses. The proposal would also provide reimbursements to U.S. territories with tax laws that mirror the Code for business credits provided to their taxpayers under this proposal and to non-mirror Code U.S. territories for credits provided under a substantially similar proposal.

Conversely, the Administration's proposal would disallow deductions for certain expenses related to offshoring a U.S. trade or business to the extent that the action decreases U.S. jobs. For U.S. shareholders of CFCs, no deduction for such offshoring costs would be allowed when determining its global minimum tax (GILTI) inclusion or Subpart F income.

This proposal would be effective after the date of enactment.

Crypto Brokers

The Administration has proposed expanding the rules requiring brokers to report to the IRS certain customer information about crypto-asset transactions. The proposal would require brokers, including U.S. crypto-asset exchanges and hosted wallet providers, to report on certain passive entities holding crypto assets with the broker and on the substantial foreign owners of those entities, as well as gross proceeds and other information reporting for brokers under current law. The Green Book explains that such reporting would allow the U.S. to automatically share information with partner jurisdictions to reciprocally receive information on U.S. persons engaged in crypto-asset transactions outside the U.S.

This proposal would be effective for returns required to be filed after December 31, 2022.

Other Proposals

The Green Book also details a number of notable proposals that are not strictly internationally focused. One such proposal would repeal Section 1061 for taxpayers with taxable income from all sources exceeding $400,000 and would instead tax income received from, and gain recognized on the sale of, a profits interest in an investment partnership as ordinary income. In addition, such income would be subject to self-employment taxes. A partnership is an investment partnership under this proposal if substantially all of its assets are investment-type assets (e.g., certain securities, real estate, interests in partnerships, commodities, cash or cash equivalents, or derivative contracts for those assets), but only if over half of the partnership's contributed capital is from partners whose interests constitute property not held in connection with a trade or business. Ordinary income treatment would also apply to any income or gain received from any "disqualified interest" in an entity, defined as convertible or contingent debt, an option, or any derivative instrument of the entity. This proposal would be effective for taxable years beginning after December 31, 2021.

Another notable proposal would treat gifts and bequests of certain appreciated property as realization events, requiring the donor or decedent (or the estate) to recognize gain to the extent that the fair market value of the property on the date of the gift or the date of death exceeds the donor's or decedent's basis in the property. For decedents, the use of capital losses and carryforwards from transfers at death would be allowed against capital gains income and up to $3,000 of ordinary income on the decedent's final income tax return, and any tax imposed on gains deemed realized at death would be deductible on the estate tax return of the decedent's estate. The proposal includes a $1 million per person exclusion for transfers by gift or at death and provides exclusions for the transfer of certain types of property and donations to charities and transfers between spouses. This proposal would be effective for transfers by gift or bequest after December 31, 2021.

Along the same lines, a trust, partnership, or other noncorporate entity that owns appreciated property would be required to recognize any unrealized appreciation if the property has not been subject to a recognition event in the 90 years since January 1, 1940. If implemented, the first recognition events under this proposal would take place on December 31, 2030. This proposal would be effective on January 1, 2022.

The Green Book also proposes limiting the deferral of gain on like-kind exchanges under Section 1031 to an aggregate amount of $500,000 for each taxpayer (and up to $1 million for married individuals filing a joint return) per year. This proposal would be effective for exchanges completed in taxable years beginning after December 31, 2021.

The Administration also remains keenly focused on enhancing resources for tax administration and strengthening tax enforcement, especially for high-income taxpayers and multinational corporations, as described in the Green Book and elsewhere in the budget.

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